85th Congress
2d Session } COMMITTEE PRINT

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INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

COMMENTS OF EXECUTIVES OF CORPORATIONS IN RESPONSE TO THE QUESTIONNAIRE

OF THE

U.S. Congress.
Senate. COMMITTEE ON FINANCE,
UNITED STATES SENATE
EIGHTY-FIFTH CONGRESS
SECOND SESSION

CHAPTER 3

Printed for the use of the Committee on Finance

UNITED STATES
GOVERNMENT PRINTING OFFICE
25420 WASHINGTON : 1958

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Vol. 3

F. W. Woolworth Co.,
New York, April 14, 1958.

Hon. Harry F. Byrd,
Committee on Finance,
United States Senate,
Washington, D. C.

Dear Senator Byrd: Reference is made to your letter of February 17, with which you enclosed a list of questions to which you desired answers, pertaining to the economy of the country. I have prepared answers to your questions and enumerate them herewith in the order in which they appeared on the list which you sent me:

1. I would define inflation as a general rise in the price of goods and services, whereas deflation represents a general decline in these prices.

2. It is questionable whether we can avoid periodic intervals of inflation and deflation under our free enterprise economic system. It would appear that under this system we will continue to have cycles, ups and downs in business. However, along with these fluctuations, it is safe to predict that free enterprise over the long term will continue to produce a rising standard of living and economic growth.

If the evils of inflation are to be avoided, at least, in part, then all the areas that contribute to inflation should be considered. A few of these contributing factors are corporate tax laws which encourage debt financing because the Government pays half the interest cost; wage boosts in excess of productivity; demands for more Federal, State and local facilities and services, regardless of the condition of the market for men, money and materials.

3. In the sense we use the term monetary control today, to limit excesses on both the up side and down side in general economic trends, one could almost say that monetary control did not exist in 1942–50. We ran a pegged bond market to make World War II and the Korean war financing as cheap as possible for the Treasury. Direct controls were introduced to restrain consumer competition for goods. Under emergency war conditions, this form of monetary control has its place.

In the light of hindsight, one might be critical of one or another Federal Reserve Board moves and their timing during the 1951–57 period. The August 1957 discount rate boost was unfortunate, and the 1954 hypodermic, under the influence of the same kind of recession, political pressure that we see today, helped foster the 1955–56 excesses that have largely produced the present recession. However, in spite of the Board's occasional miscues, its operations by and large deserve public commendation.

4. Considerable factors in the decline in the value of the dollar during the period August 1956-September 1957 were:

(1) The rise in farm-food prices due to the farm price support and related programs.

(2) The rise in unit labor cost out of proportion to productivity gains.

(3) The delayed catchup in rents with other prices as controls were relaxed.

(4) The rise in the price of services which involve labor predominantly.

5. Without meaning to sound overly critical, what has been done in the area of Federal debt management might be described as opportunistic. Should not periods of boom be used to reduce war credit debt? Should not periods of favorable bond market conditions have been used to anticipate future bunching of maturities? Should not demands on the Treasury for public works projects be minimized in boom times? Members of the Senate and the House must assume responsibility for the fact that certain of the measures they pass force the Treasury, the Federal Reserve Board, and other prudently managed Government agencies to depart from sound practices. Given acumen and objectivity on the part of our lawmakers, the public debt imposes no threat to our national credit structure or to the United States economy. In fact, properly administered, the public debt is an instrument for economic growth.

6. (*a*) It would appear that economic growth is our most important national objective. Such growth, based on a rise over the long term in per capita real income, means a rising standard of living for everyone.

(*b*) Since World War II, we have faced a relative shortage of workers. However, vast corporate investments in new plant and equipment have increased productivity. Without this stepup in productivity, inflation could have been quite out of hand.

The downswing in 1957 can probably be traced to the following: Monetary policy; repudiation of payments against defense contracts; fright freeze in placing defense orders inspired by sputnik and the business correction of the 1955–56 overstocking.

7. Government is the economy's biggest single customer. This should answer the question. However, one might add that construction spending by Government should be planned as much as possible to dovetail, not compete with private investment. The coming 2 to 3 years would appear to put an added burden on public investment as private investment takes the breather needed to absorb heavy 1955–57 outlays.

8. Taxes inevitably find their way into the price structure. For this reason, high taxes have an inflationary effect.

9. A growth economy, of course, is much to be preferred as against a stable economy. As for reconciling the dual objectives of monetary and fiscal policies. This, I believe, has been dealt with under paragraphs 3 and 5.

10. (*a*) Our present monetary system seems well geared to support a private enterprise economic society and to promote growth. As it has since the inception of the Federal Reserve System, experience should continue to improve the capabilities of monetary controls. This should provide adequate groundwork for maximum cooperation with the Treasury Department in handling its problems. But it would appear that a great deal needs to be done by the Federal Reserve Board to acquaint public and business bodies with its objectives and the plans for achieving them; and by these same public and business groups in accommodating their financial programs to the demands of the national monetary policy.

(*b*) Previously covered.

11. (*a*) Two reasons might be given for this seeming paradox:

(1) The Bureau of Labor Statistics last year published the results of a study that acknowledged what many have pointed out for a good part of the postwar period—that the rise in labor costs, in excess of productivity increases, has been the main inflation stimulus. Prices thus remain firm to rising, irrespective of employment levels. Escalator clauses and 3-year contracts contribute inflexibility features that add to the paradox.

(2) Unemployment affects primarily workers in factories and mines, and these now represent roughly only 1 out of 5 members of the United States work force. The vast remainder in banking, Government service, retail and wholesale trade outlets, and services, all maintain their need for things and relatively undiminished capacity to pay for same.

(*b*) It is not a matter of choice any more. As long as the Employment Act of 1946 remains on the books, we have the basis for persistent inflation. This act which requires the infusion of artificial stimuli to maintain full employment, tends to impede healthy readjustment even during a period of moderate downswing. However, we are all morally bound to work to minimize unemployment and the distress it can bring. This is a social luxury and luxuries usually demand something extra in the way of price. The extra price, in this case, is inflation, paid for by the consumer in rising living costs.

12. Rising private debt is a characteristic of and essential to the growth vitality of the American economy. Our businesses and people require the credit to create and buy the goods and services that go with a growing population and a rising standard of living. But debt admittedly is a leverage factor in business cycles and it might be well to examine the manner in which our tax laws encourage business debt creation and penalize moneyraising via equity financing. However, despite occasional periods of excess, rising personal debt is an essential and sound factor of United States economic growth.

13. This question encompasses a range of problems, assumptions, and possible antidotes that defy a general answer. Due to the fact that we have not utilized the boom years and the low-bond yield periods to reduce war-created Federal debt, and that the war-created tax structure was not realined to something much closer to a civilian economy, we have not left ourselves the flexible range of action that might best deal with recession tendencies.

Not having done these and other rational things, we now feel compelled to act expediently, if not wisely. It would appear that the least damaging in terms of the long-range inflation threat would be a further cut in reserve requirements by the Federal Reserve Board and a 1-year, 10 percent personal and corporate income-tax cut.

14. It would be difficult to isolate Federal deficit financing since World War II as a main inflationary force. By not having a long-term retirement program for war debt and by delaying so long after the Korean war started to impose controls, we fostered inflation. Federal deficit financing unquestionably contributed to inflation pressures, but it was probably more of a piece with other directly related causes such as farm price supports, etc.

15. There is some question as to what might be full employment under various conditions. If we cannot eliminate cycles of sharp in-

ventory accumulation and decumulation, standards of employment must be measured by the period in which we are then operating. In a large measure, however, we can approach minimal unemployment with relatively stable prices if we embrace the comprehensive attack on inflation forces as outlined above, under paragraph 2.

16. In wage contracts, combined cost-of-living plus annual productivity boosts are not matched by productivity increases, in many instances. The escalator feature usually applies in labor's favor on the rise but gets frozen into the basic wage rate before the employer can benefit during a recession period. Much more serious, the patterns of pay and cash fringe benefits set in the auto, steel, and other large industries, where price advances to customers and productivity may combine to cover most if not all the wage cost increase, tend to force other industries and companies to conform even though economically not situated to do so. These things not only do not contribute to economic stability but may have built into our wage-price structure troublesome inflexibilities.

17. The 1955 consumer durables goods boom and the 1956 capital goods boom represented a tremendous surge of economic forces within a 24-month period. Some excess of easy money in 1954 contributed to these conditions. Subsequent tight money moves were aimed at correcting these excesses. Progress was being made along these lines when the economy was gravely affected by:

1. Effects of the economy drive on defense spending beginning in the second quarter of 1957.

2. Sputnik not only jarred national complacency, but aggravated the effects of reduced payments against defense contracts by a virtual stoppage in defense-order placement for a time.

3. Then came the Asiatic flu and similar ailments that put a large part of the American population in bed for days at a time in the fourth quarter of 1957.

These random developments helped to create an economic "air pocket" under us in the fourth quarter of 1957 that accelerated the inventory decumulation. Possible remedies would seem to be: Less official reassurance; less capricious handling of defense order placements and payments, and accelerated order placement now to make up for the 1957 lagging; a further cut in reserve requirements; and, if needed, a 10 percent 1-year personal income tax cut, with commensurate easing in the business tax burden.

Respectfully yours,

JAMES T. LEFTWICH.

THE FIRST NATIONAL BANK OF CHICAGO,
Chicago, Ill., April 10, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: There are enclosed comments on the various questions which you recently forwarded to me in connection with the Senate Finance Committee's inquiry entitled, "Investigation of the Financial Condition of the United States."

I have followed your suggestions in preparing my replies. In some instances, therefore, the questions were used largely as a guide, and in other cases my replies were limited to specific aspects of the questions. I also have kept the answers brief, though a much more extended treatment of many of the subjects would have been possible.

You were generous to ask for my opinion, and I appreciate your courtesy in inviting me to contribute.

Respectfully yours,

H. J. LIVINGSTON, *President.*

1. Give a definition in your own words of "deflation" and "inflation."

I generally think of these terms in relation to the cost of living and the purchasing power of the dollar. When the amount of goods and services that a consumer can buy with a given number of dollars is reduced because of a rise in the price level, inflation has occurred. Conversely, when an increased quantity of goods and services can be purchased for a given sum of money, because of a decline in prices, deflation has occurred.

In more specific or measurable terms, I think of deflation and inflation as a discernible downward or upward trend, respectively, in the consumer price index. The word "trend" should be emphasized, for a rise in the index 1 month followed by a corresponding fall in the next month should not be considered as an inflationary move having been offset by a deflationary one. A persistent movement in one direction or another is necessary before one can decide which way the economy appears to be heading.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Short of actual price and wage controls, which are undesirable in a peacetime economy, a stable value for the dollar is not something which can be brought about by some simple mechanistic method. It is more nearly a byproduct of general economic activity and the interplay of the market forces in a free society.

Monetary and fiscal policies can be helpful in stabilizing prices by careful timing of countercyclical measures. For example, an excess

of dollars when productive resources are being utilized at near capacity levels will bid prices up. Similarly, an increase in spendable income by reducing the income tax of consumers is one method of combating a recession.

In the use of monetary or fiscal procedures for attaining price stability, I am inclined in most circumstances to prefer monetary instruments of control, and the indirect or general monetary tools to the direct and selective ones. Monetary tools are usually less blunt and more flexible than fiscal techniques. The monetary implements are sufficiently flexible and adaptable to be highly useful, provided other segments of the economy—government, business and labor—also discharge their respective responsibilities for price stability.

Monetary weapons are perhaps most effective in mitigating inflationary pressures. On the other hand, deflationary forces often require something more than monetary measures, however forcefully the latter may be applied. Thus, even very low interest rates will not encourage borrowing and investment if a high degree of pessimism prevails in the economy. In this situation, fiscal measures may be desirable.

With respect to the actual monetary tools available, I would ordinarily prefer the maximum use of the indirect tools, such as open market operations, discount rates, and reserve requirements, rather than direct controls. The former are less personal in that they make their effect felt through broad market forces.

Since labor union policies and business price practices also contribute to the elusiveness of price stability, the role of Government, short of price and wage controls, should include educating, persuading and encouraging statesmanlike behavior on the part of labor and management. Such action should aid labor and management in reconciling and compromising their differences for the welfare of the entire economy.

Price stability, in my judgment, is not the exclusive responsibility of Government. On the contrary, it is a responsibility that must also be shared by management, labor, investors, consumers and every segment of our economy, and each must discharge its responsibility if price stability is to be achieved.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942–57. (You may wish to divide the period into two parts—1942–50 prior to the accord, and 1951–57.)

From 1942 to 1945, the primary objective of the United States Government and of the entire country was to win the war. As a result, adopting measures to facilitate war financing by the Treasury was necessarily the overriding objective of the Federal Reserve System. This was accomplished by Federal Reserve support of the prices of Government securities. In the process the Federal Reserve System created the additional credit necessary for the banking system to purchase Government bonds during the war. Under these circumstances, conventional credit controls became relatively ineffective. On the other hand, central bank support of the Treasury in its financing operations was of paramount importance.

From 1946 to 1951, the Federal Reserve continued its policy of supporting the "pattern of interest rates" for Government securities, al-

though from time to time "pegging" was modified, first by dropping completely the support of short-term securities, and then subsequently lowering the support price of long-term bonds.

Since the inflationary pressure of the highly liquid state of the economy was resulting in sharp rises in commodity prices, the Federal Reserve's policy of buying all the securities offered was in conflict with conventional anti-inflationary credit policy, and contributed to the inflationary pressures. However, it must be remembered that the Federal debt has risen from $50.9 billion in 1940 to $278.7 billion in 1945, and that most of the United States Government bonds were purchased by investors at the low yields that prevailed during the war. There undoubtedly were many who believed that had the Federal Reserve dropped its stabilizing operations too suddenly or too sharply a severe decline in bond prices might have resulted with substantial losses to many holders of Government securities.

There also were some who felt that the pegging operation had certain other consequences. First, it facilitated a shift in the assets of financial institutions, primarily banks and insurance companies, from Government bonds to private debt, primarily commercial loans and mortgages. Second, in the process of shifting, the bonds acquired by the Federal Reserve System created additional reserves which permitted an expansion in bank credit. Both of these factors contributed to an expansion of productive facilities and housing which helped satisfy the pent-up demand built up during the war years. However, these increases in output were not without their costs, namely, a deterioration in the value of the currency as prices rose. Unless there is some significant national emergency, it is far better for Government financing to be conducted in free markets.

Since the "accord" in 1951, I believe one of the principal objectives of the Federal Reserve System has been to carry out policies within the monetary and banking sector of the economy that are directed toward a stable price level at high levels of employment, production and incomes (as set forth in the Employment Act of 1946), insofar as possible. In my judgment, this does not mean that the System has sought to pursue credit policies that would aid economic expansion at the cost of rising prices and a deterioration of real income. Conventional monetary management calls for credit restraint during periods of rapidly expanding business activity and rising prices, and easier credit conditions during periods of reduced activity. Admittedly, and with the benefit of hindsight, the timing of Federal Reserve actions may not always have been perfect, but again there are no mechanical standards that can fairly be applied to these problems. Federal Reserve System policy decisions must necessarily be value judgments based upon the best available economic information. There are important areas in which there is often little or no precise economic information, and in other areas there is often an unfortunate lag in the availability of data.

As I mentioned in my reply to the second question, all segments in the economy must share the responsibility for price stability.

4. Beginning in August 1956 there was an increase in the consumer price index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The years 1955, 1956, and the first 9 months of 1957 were characterized by a rapid expansion of business activity to record levels of output and consumption. This was caused, primarily, by record expenditures by consumers and business, and sustained high levels of spending by Federal, State and local governments.

All of the components of the consumer price index contributed to the increase in prices which occurred during the period August 1956 through September 1957. However, by far the greatest increase was in the price of services rather than in commodities. Services presently account for about one-third of the total index, so that the rather sharp increases in this broad component during the period help to explain the upward movement to which your question refers.

Despite substantial additions to the Nation's productive plant in 1955, 1956, and through September 1957 the demand for many items exceeded their supply. The labor force of the Nation was virtually fully employed, resulting in a favorable bargaining position for labor. As a result, increasing consumer incomes and expanding demands resulted in only moderate resistance to higher wage demands. With practically full employment, and given a choice between idle plant and an increase in wages, management understandably agreed to wage increases in a number of cases. With little likelihood of an important increase in physical output, the inevitable result of rising costs was a higher price level.

In my judgment, it is not possible to determine accurately which factors contributed most to the decline in the value of the dollar. It was, instead, the consequence of excessive activity in the economy generally. While some of the factors contributing to the rise in prices have changed in recent months, there is no evidence that once the present business decline ends that we shall not see a resurgence in strength of inflationary pressures. Consequently, the persistence of the threat of future price rises, despite present declines in production and employment, necessitates weighing with great care changes in monetary and fiscal policies.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

One of the objectives of Treasury debt management policy at this time is to shift an increasingly larger amount of the marketable portion of the debt into longer term maturities.

This policy could have at least two effects upon the credit structure of the United States: First, as the Treasury extends the average maturity of the Government debt, it becomes more competitive with long-term private borrowers, such as public utilities and industrial corporations. This result, however, is not of such significance that it should necessarily deter the Treasury from the ultimate attainment of this objective.

A second possible consideration is the effect of stretching out the debt on the commercial banking system. As the Treasury increases the proportion of longer-term bonds, the supply of Treasury bills may tend to decrease.

In recent months, the loan demand of banks has declined and reserves have increased, thereby affording the commercial banks some opportunity to improve their liquidity by increasing investments in

short-term Government obligations. Partly as a result of this increased demand, the bill rate in the past few months has experienced one of the sharpest declines for such a short period of time in history. In these circumstances any reduction in the supply of bills which might be made as the Treasury lengthens the maturity of the debt, would tend further to depress the yields on bills.

With a large amount of the debt having comparatively short maturities, it is in general beneficial to the Treasury to lengthen the overall maturity of the debt. However, it also is necessary to maintain an optimum balance between short, medium, and long-term Government issues, in order to maintain relatively stable money markets and to provide the short-term obligations necessary for the economy to maintain needed levels of liquidity.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy of the United States:

1. Price stability.
2. Stability of production, demand, and employment.[1]
3. Economic growth in production, demand, and employment.[1]

(*b*) With respect to these three objects, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

In my judgment, price stability, providing for stability in the short run, and for growth over time, in production, demand, and employment, are equally important economic policy objectives of the United States. It is not a question of whether we desire either price stability, or stability or production, demand, and employment, or economic growth. Actually, no one of these objectives is expendable. We must have all three if we are not to have declining standards of living for an increasing population.

The postwar period has demonstrated that despite the progress we have made in economic analysis, monetary and fiscal management, and in limiting the magnitude of fluctuations in the business cycle, we have not succeeded in smoothing it out completely.

The current period of adjustment with its decline in employment, incomes, and spending is further evidence of this fact. Even though we may not have succeeded in achieving price stability and economic growth in production, demand, and employment does not warrant altering our objectives or pursuing them any less vigorously than in the past.

On the other hand, the restlessness of the business cycle may be a characteristic of an individual initiative private enterprise economic system. There are in the market place of a free society self-perpetuating economic forces that help gradually to correct maladjustments that have occurred during the previous period. For example, perhaps a wave of overoptimism has stimulated an unsustainable rate of spending and investment that must be correct if the economy is now to be brought into balance for a new period of growth and progress. Such adjustments probably are inevitable in a society of freemen where the possibility of rewards and profits is accompanied by the

[1] It is assumed that "stability" as contrasted to "economic growth" refers to smoothing the fluctuations about the rising trend line which would describe growth.

possibility of risks and losses. However, this is not to suggest that efforts should not be made to mitigate these fluctuations and to alleviate the hardships of those who become unemployed.

Perhaps the most striking trend during the years since our emergence from World War II has been the continued vigorous growth of the economy. Related to this is the dynamic role played by private investment—in furthering the growth of existing products, developing new products, and ever broadening our economic horizons. The major cost of this success has been, of course, our postwar inflation. However, with continuing improvement in economic analysis, and monetary and fiscal management, there is reason to believe that the costs due to instability can be reduced. The year 1957 marked the beginning of what is currently a test of our ability to cope with recessionary forces. Our success in meeting this challenge will present us with additional evidence of our ability to combine, in reasonable fashion, our goals of growth with minimum instability.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

The current rising volume of Government spending tends to sustain the level of business in a period when the aggregate expenditures of business and consumers are declining. During periods when individual incomes, consumption and employment decline, an increase in Government expenditures contributes to demand and tends to counteract and offset the drop in production and business activity. The larger volume of spending contributes to income, new orders, production, and employment. Conversely, during periods of rising private demand and expenditures, Government spending, except that which is essential, such as national defense, should be reduced so it will not create excessive demands on the economy.

However, there is no certainty that increased Government expenditures will necessarily meet the problems of a period of recession effectively. For example, even after a decision is made to increase Government expenditures, there may be considerable lag in implementing the policy. As a consequence, there frequently is the risk that by the time the results of increased Government spending are felt in the economy in the form of an expanded demand for goods and services, the decline in general business may already have ended. Thus, the increase in demand resulting from expanded Government expenditures actually may occur when the Nation's resources and productive capacity are being fully utilized as the result of an expansion in private demand that had subsequently developed.

Moreover, experience indicates that these projects for Government spending often result in far larger expenditures than had originally been intended. Furthermore, it is exceedingly difficult to reduce the level of Government spending after it has been expanded.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

It is widely believed that if Government spending is equal to tax revenues—that is, if Government budgets in the aggregate are balanced—there is no effect on economic activity because the Government is putting back into the economy as much money as it is taking out. However, this conclusion is not correct.

That share of Government expenditures which is used to purchase armaments, for example, contributes to the income flow of the com-

munity, but in the process no consumer goods are created to satisfy consumer demands. Thus, though the Government budget is balanced, there may actually be inflationary consequences resulting from Government spending. In general, the larger the budget, even though balanced, the greater the probable inflationary impact.

The portion of income which is diverted to Government by means of taxes is socialized. Furthermore, as a large proportion of national income passes to governments by means of taxes, the freedom of expenditure choice of individuals and private business is reduced.

A consequence of the socialization of income is the effect on the economy of Government expenditures in contrast to consumer and business spending. The goods and services purchased by Government for military purposes quite obviously differ from those that would be bought by the private sector of society. In the former instance, the manufacturers of heavy equipment, electronics, and aircraft might be most involved. In the latter case, purchases by consumers probably would be divided more equally among durable and nondurable goods industries and services, including travel and recreation.

Finally, there is the danger that increasingly higher taxes reduce incentives of the American people to work harder and to continue to assume capital risks—two necessary conditions of economic growth in a private enterprise society.

Related to the foregoing danger is the possibility that the percentage of the consumer dollar taken in taxes ultimately could rise to a level where the standards of living of the American public would actually decline because of taxpayments. Since an increasing standard of living is one of the primary objectives of public policy, taxes must not be raised to a level where a large volume of private consumption is impossible.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes and debt) and monetary and credit policy, and relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Fiscal policy refers to the Federal Government's authority to tax, borrow, and spend in order to discharge its constitutional responsibilities. It also includes the management of the public debt.

Monetary policy involves control of the volume, availability, and cost of credit, and is the responsibility of the Board of Governors of the Federal Reserve System.

Both fiscal and monetary policy can be effectively mobilized to restrain inflationary trends, thus contributing to price stability. The inflationary effects of Government spending can be reduced by a balanced budget. If, however, expenditures exceed receipts and a deficit results, the inflationary pressures in these circumstances may be moderated to the extent that the Government is able to borrow from nonbank investors since this procedure does not result in an increase in the money supply.

Monetary policy in times of high business activity can be useful in restraining inflationary pressures by limiting the volume of credit expansion to that which is required to meet seasonal and other productive needs of the economy. By limiting the expansion of credit and the volume of money during a period in which demand is tending

to outrun the supply of savings, the monetary authorities apply a brake to the economy. This should reduce inflationary pressures and limit possible economic excesses that might occur.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

One of the important problems with which the monetary system of the United States will be faced in the future is an adequate supply of money to support expected higher levels of economic activity. It is generally recognized that in the past there has been a fairly close relationship between economic growth and the money supply. Higher levels of economic activity require larger amounts of money and credit. It will be necessary therefore, for the money supply to expand in the future in order to support the expected higher levels of production in the years ahead. The monetary authorities, therefore, must consider not only the current economic situation, but also must plan now to meet the future demands of the Nation. In my judgment, such monetary policy decisions, in general, often are of more importance and significance than the framework or structure of the monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

One of the desirable long-range, over-all objectives of the fiscal policy of the United States ought to be a generally reduced level of taxes. The attainment of this objective, in a very large measure, is determined by public finance and fiscal policy decisions, both legislative and executive, regardless of the particular system in effect. The following are merely typical of the problems I have in mind:

1. What is the limit to the growing magnitude of Government expenditures? The socialization of personal income that the rising trend of Government expenditures implies assumes that Government expenditures bring a greater benefit to the community and the Nation than would the individual disbursement of some portion of these tax revenues. There are no reliable criteria for determining that funds expended by direction of the Congress are better spent than when the purposes of the expenditures are determined by individual and business decisions.

2. What is the effect on incentives, over a period of time, of Government spending? Admittedly, some Government spending spurs incentives. The Government road-building program, for example, may be looked upon with favor by some industries. On the other hand, it seems clear that increasing taxes eventually must adversely affect various incentives.

3. There is always the possibility that the fiscal policies of the Government will conflict with the monetary policies of the central bank. The history of central banking suggests that the problem is not peculiar to a particular system or country.

In general, therefore, fiscal decisions are in most instances more important than a particular fiscal system.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

The seeming paradox of the existence of inflation and unemployment at the same time in our economy results from the fact that the

two conditions are not entirely governed by the same influences or factors. Rather, they often respond to different and unrelated pressures that may be operative at the same time.

Currently, for example, the decline in industrial production and the rise in unemployment have been largely in the durable goods producing industries. This development can be attributed to reduced demands. First, business investment in plant and equipment has been curtailed from previous, exceedingly high rates. Second, consumers have altered their buying patterns, curtailing their purchases of durable goods and spending more on soft goods and services. As a consequence of these declining demands, production schedules in the durable goods industry have been curtailed and unemployment has risen in these areas.

The cost of living, on the other hand, and the consumer price index in general, which have been rising steadily for several years, have continued to edge up in recent months despite the rise in unemployment. A number of factors have contributed to this development. First, despite the drop in employment and incomes, consumer demand for goods and services has been maintained in volume close to former high levels. Second, spending by families for services such as utilities, medical care and rent, amounts to about 35 percent of disposable income. As a result, prices for consumer services in the last 8 years have risen about three times faster than prices for goods and commodities. Third, because of the nature or character of consumer spending, much of it may not be postponed or deferred. These factors in the aggregate have operated and contributed to demand pressures on prices notwithstanding the decline in the output of durable goods and the rise in unemployment.

(*b*) Shall we accept as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

I do not believe that inflation is desirable or is a necessary condition of full employment. It would be a grave error of major proportions if it became generally accepted that a gradual rising level of prices was an inevitable and necessary condition for full employment. Such a development, in my judgment, would have a number of extremely undesirable consequences. The most significant, probably would be that it would tend to discourage saving which is basic for further investment and subsequent economic growth. The problem has been complicated in recent years because our degree of tolerance of unemployment has become so narrow. While conceding that unemployment is an economic waste and socially undesirable, its complete avoidance at the expense of persistently rising prices may prove to be even more costly.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Certain individuals and certain segments of the economy may have gone into debt to a point where any significant decline in their income may make it difficult for them to discharge their obligations promptly. However, it is doubtful that the growth of the aggregate private debt of the entire Nation in recent years has become an actual threat to the stability and vitality of the American economy.

Savings by individuals and by business are a vital part of the capital creating process. Thus, the accumulation of savings and their subsequent investment are the means whereby a Nation's wealth grows in the form of industrial plant and income producing assets. The savings of the Nation, therefore, must continue to grow if the Nation is to expand its productive assets in the coming decades. It is widely held that capital investment expenditures should be financed primarily by the noninflationary means of mobilizing savings. Savings are channeled into productive uses by means of equity instruments of finance, such as stock or proprietorship interests, or by means of fixed obligations. The latter process involves the conversion of savings into debt instruments, that is, bank loans, bonds, and mortgages. In this respect, the growth and creation of debt also plays a vital role in the capital creation process.

In the long run, economic growth would be reversed and cumulative deflation would become a problem if saved dollars were accumulated and remained idle instead of being converted into factories, machinery, and other income producing assets. In order to transform a steadily growing supply of savings into national wealth, some individuals must be willing not only to risk their capital in equity ventures, but they also must be willing to borrow already accumulated funds.

The banking system is related to this question of debt, savings, investment, and capital creation as it is the most important credit creating agency in the country. An expansion of bank credit, so essential to the continued steady growth and functioning of a private enterprise economy, is possible only if there is a corresponding increase in debt. Debt creation by banks is one of the significant processes by which the country has increased its capital wealth, productivity, national output and income.

In the last analysis, the risk is not solely in the debt, but rather in its rate of growth compared to the accumulation of savings and equity in the community. An excessive rate of increase in the debt will create problems and subsequent periods of adjustment. For example, an inadequate rate of increase in debt may so hamper the economic growth of the Nation that the standard of living of the people fails to advance or actually declines. On the other hand, excessive credit expansion may cause an unsustainable volume of spending, overinvestment in plant and equipment, excess capacity, and price rises. A period of adjustment inevitably follows.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

In my judgment, there is no categorical answer to this question. The social sciences and economics, in particular, in contrast to the physical sciences, are not exact and are not always amenable to precise measurement. It would be a greatly different world if one could devise a formula that would clearly and precisely indicate the time and changing pattern of fiscal and monetary policy that would be appropriate under varying conditions. Unfortunately, this is not possible, and no reliable mechanistic approach to solving this question is known. Instead, the determination of appropriate policy requires a

continuous evaluation of the various economic factors and indices of business activity. This, in short, involves an extremely difficult evaluation of economic forces, many of which are not clearly defined nor subject to accurate measurement, and the making of value judgments.

Furthermore, there is no adequate permanent guide or bench mark that can be used in making the monetary and fiscal decisions required to counteract a downturn in the economy. To illustrate, our degree of tolerance of unemployment seems to have narrowed considerably in the postwar period. We seem also to prefer various types of Government action rather than the economic discipline which may sometimes be necessary to correct maladjustments that develop when the economy has been excessively active.

There is, therefore, no known, or generally accepted, point in terms of unemployment, production and consumer demand that would indicate when the Federal Government should move in a major way to halt and reverse a downturn in the economy. Instead, it requires a comprehensive evaluation of the entire economy and probably should not be limited to the three factors suggested above. In the current situation, for example, the recent behavior and current level of prices should also be a part of the evaluation.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

In 5 of the 11 postwar years, receipts of the Federal Government exceeded expenditures and the budget showed a surplus. Of the 6 years of budget deficits, 3 occurred during hostilities in Korea. Excluding the 3 years of Korean military operations, Federal deficits occurred in only 3 of the 8 postwar years. Furthermore, the public debt increased $18 billion during the entire postwar period, or an average annual increase of $1.6 billion. This compares with the very large increase of over $200 billion in debt during the war, which was reflected in a correspondingly large increase in the liquid assets of individuals and corporations. The banking system also was in a position to expand credit considerably. These conditions, coupled with a tremendous pent-up demand for goods and services by business and consumers, occurring when output was rather limited, obviously put pressure on the price structure. Inflation was the result.

On the other hand, the comparatively moderate rise in the Federal debt in the postwar period compared with the war years, and the approximate balance in the number of budget deficit and surplus years, suggests that the postwar inflation must be attributed mainly to the very large volume of deficit war financing. However, it seems likely that if the Federal Government had been able to operate at a surplus during the postwar years, the rise in prices might have been somewhat more moderate.

15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

I believe relatively full employment can be attained while maintaining the reasonable stability of the purchasing power of the dollar. Although as I pointed out (questions 2 and 11 (b)), the problem becomes increasingly difficult as our degree of tolerance of unemployment narrows. The avoidance of temporary periods of high unem-

ployment and the attainment of orderly economic growth with a stable dollar depend upon how the community values these objectives relatively. Attaining these objectives, however, is not the sole responsibility of Government, but in addition requires, among other things, a balanced distribution of expenditures among the three primary spending units in the economy—consumers, Government, and business.

Assuming that monetary and fiscal policies are appropriate, the objectives of full employment and a stable dollar may require the various segments of the economy to modify and amend their programs. I am not suggesting that this be accomplished by Government edict, but rather by self-disciplined, responsible action of the groups concerned. For example, governments may be obliged to alter or postpone certain capital spending programs when the economy already is operating at capacity. Business might find it possible and more economical to budget its investment expenditures somewhat more evenly over the years. In 1956, business spending on plant and equipment increased 25 percent, compared to an anticipated decline of perhaps 10 to 15 percent in 1958. Labor bargaining techniques, wage demands, and pricing policies may require review and possible modification. The behavior of consumers also may be a contributing factor to economic stability and instability. It would be helpful therefore if fluctuations in consumer spending could be moderated. The above are only suggestive of some of the changes that might assist in achieving the goals of reasonably full employment and a stable dollar. All segments of the community must be persuaded to place these objectives above other competing economic goals.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

It is assumed that economic stability refers essentially to price stability, for we must have economic growth even to maintain present standards of living for an expanding population. It is doubtful that the escalator provision contained in wage or other contracts contributes to price stability.

I do not believe it would be economically desirable to have the escalator clauses widely used in industry. These clauses add cost rigidities in our pricing system that could cause cumulative instability in our economy. For example, if for some reason there were a sudden inflationary stimulus imposed on the economy, e. g., a war scare, an automatic wage increase would follow. This, in turn, would create new upward pressures on costs and prices, and the process of wages and prices pushing each other might become a permanent structural rigidity that would be undesirable. Wage increases ought to be closely related to increases in productivity rather than to the cost of living.

The forces of competition and the search for profit operate in such a manner as to induce businessmen to substitute other factors and methods for those which become more costly.

Improvements in technology come about in response to management's search for greater profits enforced by a lively spirit of competition. A reduction in costs is only one way of improving profits. Technology also applies to the development of new markets and new products—again in the search for profit, and forces which restrict competition and dull the profit motive are harmful to the efficient operation of a free enterprise system.

17. List and briefly discuss what you consider the causes of the present recession: and what should be done to terminate it.

Obviously, no one can say with any degree of certainty what caused the present recession. However, one factor stands out when reviewing economic developments in the past 3 years. I refer to the accelerated unsustainable rate of increase in spending that occurred in a number of areas. This is being followed by a period of adjustment during which conditions revert to a more normal rate of increase.

In the latter months of 1953, business activity began to decline. As a consequence, the Federal Reserve authorities shifted monetary policy to one of active ease. On January 1, 1954, a reduction in personal income taxes became effective and the corporation excess profits tax instituted during the Korean incident expired. As a result of these and other developments, expenditures of consumers in 1954 rose about 20 percent. Outlays for private residential building, for example, also increased, rising 22 percent above the previous year, and housing starts neared the postwar high of 1,396,000 units. A major factor here undoubtedly was liberal FHA and VA financing arrangements, as 65 percent of the housing starts in 1955 were Government insured. An abundance of credit and easier terms also was an important factor in automobile sales, and a record 7.3 million cars were sold in 1955. Total consumer credit, as a result, increased 20 percent. It became increasingly apparent, as the year passed, that such rates of increase in consumer spending were not sustainable.

In 1956, encouraged by increased profits, rising consumer income and demand, businessmen expanded facilities. Individually, these decisions were quite rational as each company attempted to increase capacity in order to make certain that it retained its share or an increasing share of expanding consumer demand. Collectively, business investment in new plant and equipment in 1956 increased 25 percent. This, again, was not a sustainable rate of increase. This spending by consumers and business was accompanied by a demand for credit. Investment spending grew much more rapidly than accumulated savings, and much of the excess demand for credit found its way into the banking system. As a consequence of these various forces, the business loans of all commercial banks in the three year period, 1955 through 1957, increased about 50 percent.

While consumer spending continued to rise in 1956 and through most of 1957, the rate of increase was considerably below 1955. In similar fashion, business investment also increased in 1957, but at a much slower rate. By the third quarter of 1957 it became apparent that some excess capacity existed and business spending plans were being pared down. Thus, with the benefit of hindsight, it can be suggested that the current recession is in part the result of an unsustainable rate of increase in consumer spending which in turn tended to stimulate too rapid an increase in capital spending. One byproduct of these two developments has been an adjustment in inventories which began to develop early in 1957 and accelerated in the final quarter. A further contributing factor to declining production was the reduction in the Federal Government purchases of goods and services and the slow down in contract payments and new Government orders that occurred in the latter part of 1957.

Such excessive economic activity inevitably is followed by a period of adjustment. During this period, it becomes the responsibility of government, first, to alleviate the individual personal hardships of those unfortunate enough to be unemployed. Second, monetary policy should be directed toward easing credit and stimulating business activity. However, some self-correction of the economic maladjustments and excesses that develop in a boom period should be permitted if the economy is to go forward on a sound basis. Should the present adjustment persist, further government action might be desirable in the form of some reduction in taxes, coupled with some alteration of the tax structure, with the objective ultimately of a lower level of government spending.

FIRST & MERCHANTS
NATIONAL BANK OF RICHMOND,
Richmond, Va., February 25, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate,
Washington, D. C.

DEAR SENATOR BYRD: In your letter of February 17, you invited me to comment on the economic condition of the United States, using a list of questions which you enclosed merely as a guide. May I say in the beginning that I am cognizant of the complexities of the financial lives of our individuals and corporations and certainly I do not think that I have the answers. I am glad to state my beliefs and hope that when added to those received from many others, they may be helpful.

For some years we have been seriously concerned with inflation in this country. Now certainly we are worried about a deflationary period. Inflation is the erosion or decline in the purchasing power of our unit of currency, the dollar. Deflation is just the opposite, where the unit of currency gains in purchasing power. Some economists have a simple definition saying that inflation means there is more money than there are goods available. Whatever the definition, the average man is concerned lest the dollar he saves today will buy a smaller amount of goods in the future.

I do not believe it will be possible for the Congress of the United States to enact laws which will prevent business cycles and at the same time allow the citizens to retain their liberties. We cannot repeal the economic law of supply and demand. If we are to have a free-enterprise system, we must have competition. In this system, periods of overbuying and underbuying are inevitable. While we cannot eliminate business cycles in a free country, we can provide certain brakes and stimulants. One of these is a certain amount of monetary control.

The Federal Reserve Board has certain powers by which it can make the money supply more abundant or less abundant. Through raising or lowering reserve requirements and discount rates to its member banks and also through certain open market operations, it can make money more or less available for banks to lend to industry and individuals. These moves by the Federal Reserve can have a tendency to stimulate business or curb a boom. They are not absolute controls. They do not always take effect quickly. For instance, no matter how cheap money might become, if business and individuals were pessimistic about the future, they could not be forced to borrow to expand business. Nevertheless, in my opinion, it is a fine thing to have these powers in the Federal Reserve Board and I believe they have been used wisely in recent years. Since the socalled accord between the Federal Reserve and the Treasury Department in 1951,

there was a remarkably stable period until the middle of 1956 insofar as consumer prices were concerned. Then wage increases granted by industry and largely passed on through price increases to the consumer, caused a jump in the consumer price index. An increase in wages to labor without corresponding increased productivity is inflationary. This is an aspect of inflation which Federal Reserve powers over money cannot touch. Another is that of the Federal Budget operations.

Big Government spending seems to have become an entrenched part of our economy. Withdrawal or drastic reduction of this spending certainly would be very deflationary, if not catastrophic. Nevertheless, a gradual reduction in Federal spending would certainly help to combat inflation. The use of budget surpluses to reduce debt rather than to reduce taxes is wise during boom periods as it serves to reduce the supply of money and thus to keep prices from rising. Taxation is of course deflationary. Theoretically when our country is in a depression, taxes should be reduced in order to increase the supply of money available for spending.

You have raised the question as to which is more desirable, price stability or stability of production and employment; or whether growth in production and employment is more desirable. Of course if we could have steady employment, growth in production, and price stability we would be in a millennium. I do not see how this could come about. It has been said by some that in order to maintain full employment, which is most desirable, we must become wedded to gradual but mild inflation. I am very strongly of the belief that the advantages of full employment are more than offset by creeping inflation. I do not believe we should adopt it as a way of life. One of our great financiers has stated "Those who seek to promote maximum production and employment by creeping inflation, induced or aided by credit policy, are trying to correct structural maladjustments by debasing the savings of the people and undermining the system of democratic capitalism which we have done so much to develop." A 2 percent per year rise in prices compounds itself so that in 20 years the cost of living will have gone up 48 percent. This would certainly tend to destroy thrift and would harm the willingness to work of our people. Efficiency of production of goods would be reduced. Periodic, mild adjustments in our economy would certainly be far better, over the long run, for everybody. Certainly, in times of unemployment, the Federal Government could be expected to engage in public works and tax cuts to counteract the downturn in the economy. On the contrary, during boom periods, as I have stated before, the surplus should be used for debt reduction and not tax reduction and also there should be a minimum of public works.

I do not believe that escalator provisions in wage contracts are compatible with achieving economic stability. An increase in wages without on increase in productivity is inflationary. The inflexibility of wages, reflected in prices prevents small periodic and desirable economic adjustments.

I have not tried to answer all of your questions, first because I do not know the answers to all of them, and second because in our free

enterprise system I believe business cycles are inevitable. I conclude by expressing the hope that the full independence of the Federal Reserve System and its present powers be maintained so that it can continue to provide a brake or a stimulant to business, as needed.

With assurances of high regard, I am,

Sincerely,

ROBERT T. MARSH, JR., *President.*

SEARS, ROEBUCK & CO.,
Chicago, April 3, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Enclosed you will find our response to the questionnaire which you sent to me earlier. This reply has been prepared by Mr. Arthur Rosenbaum, who is in charge of our economic research department.

The replies to the questions concerning inflation are based upon studies which Mr. Rosenbaum and his staff have been carrying on for some time. Answers to the questions on current business conditions and the economic outlook reflect the factors which Sears takes into consideration in our own planning of operations.

I appreciate the opportunity to submit Sears' viewpoint on these matters and hope that this information will be useful to the committee.

Very truly yours,

F. B. MCCONNELL.

1. Inflation may be described as a substantial rise in the general price level. Deflation, to be consistent, should be described as a substantial decline in average prices, but there is an associated connotation of declining production and rising unemployment. These were traditionally associated with declining prices but we now have declining production and considerable unemployment, yet with no reduction in the price averages; in other words, business deflation without price deflation.

2. Inflation generally results from an excess of demand in relation to the ability of the economy to produce goods and services. If, at the same time, the labor market exhibits the following characteristics: (*a*) relative tightness of supply; (*b*) strong labor organizations in leading industries, enjoying better-than-average gains in sales and profits; (*c*) automatic wage increases on a periodic basis to workers in these leading industries, which are relatively greater than the average increase in output per man-hour for industry as a whole; and (*d*) resistance to downward wage adjustments during business declines, the inflation is intensified and prolonged. The growth of inflation may be slowed down somewhat by reducing excessive demand; the Government sector can contribute by reducing spending, eliminating postponable programs and curtailing others, while maintaining tax rates high enough to yield a surplus.

The money supply can be kept from rising so rapidly as to facilitate an excessive rate of spending, by exercising the monetary powers of the Federal Reserve Board. But Government monetary and fiscal policy can do little to halt the rise in wage rates. Such efforts to restrain price inflation may result in a considerable amount of unemploy-

ment, with a greater disparity in wage rates among the different industries. We must find a way to relieve the unremitting pressure on prices caused by excessive increases in wage rates. We must also make full use of existing legislation to insure the existence of free competitive markets in which the interplay of changing supply and demand will be reflected by corresponding changes in prices.

Counterdeflationary measures would include easier credit policies and tax cuts aimed at increasing and stimulating both consumer buying and business investment. If these are insufficient, increased Government spending on a backlog of useful public works projects, held in readiness for such a contingency, should be resorted to.

3. The relative ineffectiveness of the Federal Reserve Board's powers to suppress inflationary demand through control of the amount of bank credit, was demonstrated in the 1955–57 period when the quantitative restrictions on the money supply were partially circumvented by a growing rate of money turnover. Thus spending actually increased to an excessive degree. It is doubtful that more stringent measures could reasonably have been attempted. This seems to demonstrate that monetary policy does not deal directly enough with the basic forces of inflation to warrant our reliance upon it as the main weapon against inflation.

4. Both services and commodities participated almost equally in the rise of the consumer price index during the period cited—August 1956 through September 1957. The increases in costs of such services as: home maintenance and repair work, auto and TV repairs, barber and beauty shop services, domestic service and transit fares, are primarily due to the obviously higher costs of labor involved in producing these services. Using labor in a broad sense, this statement also applies to fees for medical, surgical, dental, and hospital services. Turning to prices of consumer goods, we note first that retail prices have by and large been governed by changes in factory prices. The best available data seem to indicate that unit labor costs in manufacturing have been rising over the years.

Declining costs of raw materials prior to the recent rise had helped keep factory prices fairly stable but when raw material prices stopped declining, and even rose somewhat in 1956 and 1957, this eliminated an important offset to the upward trend in unit labor costs. Result: higher wholesale prices and higher retail prices. The common factor in the trend toward higher prices of goods and services is the long term trend toward higher prices of goods and services is the long term trend toward higher unit labor costs, which might be called wage inflation, brought about by wage increases in excess of the increase in productivity.

5. We agree with the points set forth on this subject in the article entitled "Federal Financial Measures For Economic Stability" in the Federal Reserve Bulletin dated May 1953.

6. (*a*) When prices are rising, demand, and therefore production and employment as well are temporarily stimulated. When prices are declining, buyers tend to pare orders to immediate needs, partly because of the change in inventory policy during a time of sales decline (usually associated with declining prices), but also because chances for reordering at even lower prices are good. Thus lack of stability in prices tends to exaggerate fluctuations in demand, production, and em-

ployment. The case for price stability is impressive from other independent considerations. When it appears that price stability can be viewed as a means of obtaining stability of demand, production, and employment, we must conclude that the former, price stability, is at least as important an objective of economic policy as the latter.

Price stability is an aid to sound, orderly economic growth. It reduces some of the risk involved in investing in new plant and equipment, thus encouraging a more evenly-spaced flow of capital expenditures. Fluctuations in the cost of money, entailed by measures for restraining or loosening the credit supply, are not as influential in investment planning as are changes in the actual costs of the capital goods and in the prices and prospective profit margins of the goods to be manufactured by them. Again price stability would appear to take precedence. The 3 objectives stated (perhaps qualifying economic growth by the adjective orderly), are actually 3 facets of 1 objective, a strong economy. When we try to treat the symptoms of reduced production, demand, and employment without curing the disease of price inflation, we do not restore its state of health.

(*b*) The most important factors in price trends since World War II were:

(1) The more than 100 percent increase in the money supply over the war period which provided the monetary basis for the subsequent inflation.

(2) The great increase in the bargaining power of labor due to the gains in labor organization and constricted labor supply in general. Not only have the productive age groups in the population expanded less rapidly than the dependent age groups (children and aged) but the needs of the Armed Forces and defense production have removed much of the cream of the labor force from civilian production. At the same time, prolongation of the average time spent in school has reduced the normal flow of new entrants into the labor force.

(3) The combination of labor union power and high employment has not only helped labor in obtaining greater wage concessions in leading industries but in spreading the wage increase pattern faster and more thoroughly throughout industry generally. Even though it may be debatable whether the increases in wages and other benefits obtained by steel and auto workers, for example, justified the amounts of price increases, the increases in employment costs generally have outstripped the gain in production so that unit labor costs in general have been rising.

(4) Correction of inflated prices which would bring about an earlier revival of demand and employment from depressed levels is hindered by the "stickiness" of labor costs. In fact, automatic increase provisions in labor contracts covering many more workers than at any time in the past, may actually result in even higher unit labor costs.

The most important influences upon production, demand, and employment since World War II have been:

(1) The backlog of consumer needs for durable goods and residential construction built up from the pre-war and World War II periods, partly financed by savings during World War II, was mainly responsible for the production boom in the early prewar years.

(2) The high rate of Government spending initiated by the Korean war.

(3) The great increase in number of families after the end of World War II, laying the basis for a continuing high level of demand for durable goods and homes for many subsequent years.

(4) The great expansion in mortgage and consumer debt which helped finance the large volume of homes and durable goods produced in the last 5 years.

(5) The strong surge of demand for plant and equipment in 1955–57. Many industries were actually operating too close to capacity in the peak year 1953, indicating a real need for expansion. Business confidence was high, the economy having successfully withstood the test of two downturns without serious results, and prospects for further growth were bright. The liberalization of depreciation computation for tax purposes was a contributing factor.

(6) Consumer confidence and buying power in the 1949 and 1954 recessions was sustained by social security, unemployment compensation, bank deposit insurance, and the agricultural price stabilization program.

(7) The monetary policies of the Federal Reserve Board. Economic growth has been facilitated by—

(1) The growth in population—the birth rate has remained relatively high and the death rate has slowly declined.

(2) Technological progress—we have been spending an increasing proportion of our national income for research to learn how to produce goods and services more cheaply and to develop new products.

(3) Investment—the new machinery and plant needed to translate the results of research into practical use have required the investment of large amounts of savings which are nourished by profits.

(4) Sharing of gains due to increased productivity—unless labor receives a fair share of these gains, consumer purchasing power will not support continued growth of productive capacity.

7 and 8. One out of every seven persons, or 15 percent, who were either on military duty or at work in 1957, drew his pay from Government—Federal, State or local. But in addition there were many more, an uncounted number, employed on private payrolls whose jobs were dependent on Government contracts connected with the defense program or otherwise. Another measure of the relative impact of Government spending is through an analysis of the gross national product figures. Government purchases of goods and services accounted for 20 percent of total demand in 1957. Since, in addition, close to $20 billion of consumer income in 1957 was in the form of Government transfer payments, virtually all of which is currently spent, it would appear that about 24.5 percent of the total demand for goods and services was supported by Government-disbursed funds. The national security program was responsible for less than half of this figure or 10 percent of the total gross national product. The nonmilitary portion of Government spending contributes to economic stability in the sense that it is relatively unaffected by business declines; it may even rise during such periods due to increased unemployment compensation payments or acceleration of public works construction.

Government spending for goods and services is justified to the extent that these are essential to the welfare of the community as a whole and it is inappropriate for private industry to do the job. A

good or service furnished by private industry can only remain profitable so long as prices are competitive and enough people want it at that price. These tests are inapplicable to goods and services supplied by Government. Hence, to the extent that Government increases its activities, paying for them by corresponding subtractions from business and consumer income, it is also substituting the judgment of a few for the judgment of the market place in deciding the direction of economic development. The same departure from freedom of choice by consumers is reflected in a tax structure which discriminates against certain types of goods (excise taxes), certain types of services (transportation, communication, and entertainment), or even against goods in general as compared with services (sales taxes).

9. Monetary and credit policy has the advantage of being comparatively flexible in that it can be changed as soon after the occurrence of a shift in business activity as can be definitely determined from expert analysis of current data. It is also capable of variation to achieve differing degrees of effect. Since there is a lag in the receipt of economic information, another lag before a turn in economic activity is definitely confirmed, and imprecise knowledge of the timing and extent of the possible impact upon business activity which could be associated with particular changes in monetary policy, it cannot be said that monetary policy is a sensitive tool in a strict sense. We have already described how a rise in the rate of money turnover at least partially nullified the tighter credit policy during the 1955–57 period of inflation. The role of monetary and credit policy is commonly judged to be of less importance in promoting a revival of spending than in dampening excessive spending. Other incentives must be present than cheaper costs of borrowing money to encourage spending.

Spending and taxing programs are procedurally even more sluggish in relation to economic trends. Changes in fiscal policy are most apt to be decided upon when the business cycle is close to its trough or peak, with a further lag before the full effect is reached. It is possible, for example, that spending programs appropriate for a time of recession may be in full swing after recovery has taken place intensifying the upswing to the point of stimulating another wave of price inflation. The housing bill of 1954 resulted in a housing boom in 1955, a year when other types of construction were also at a peak. The relative inflexibility of fiscal policy may easily result in lack of coordination with monetary and credit policy, the two falling out of phase with each other, and intensifying the problems confronting the monetary authorities.

Tax revision measures may have more immediate effects on spending, but there are grave differences of opinion as to the type of tax revision which would be most effective in a particular situation. There is, besides, the danger that a revision in tax rates deemed desirable for immediate purposes may not be appropriately wise for the longer range. The long-standing problem of comprehensive reform of the tax structure may be made even more difficult to solve because of the patchwork measures adopted under emergency conditions. Actually, the progressive income tax system we now have automatically reduce the tax burden on individuals somewhat more rapidly than incomes are reduced.

The budget deficit arising from increased Government spending, or reduction in taxes, or a combination of both, must be financed by an increase in public debt. This tends to weaken the restraining power of monetary policy as a force against price inflation.

10. (*a*) In the case of individual commodities and services produced under our free competitive system, the supply is automatically adjusted to the market demand by changes in prices, which by altering the gap between costs and prices, result in reducing or increasing production as needed. But the supply of money, the most important commodity of all, because it serves as the universal standard of exchange in trade for all other commodities and services, cannot similarly be left to adjustment by market forces without greatly intensifying the amplitude of business fluctuations. The fact that our monetary system must be continuously kept under surveillance and manipulated is its greatest weakness. One of the most important problems facing the monetary authorities is to preserve the purchasing power of the dollar. This involves control of the money flow so that it is kept in proper relation to the flow of goods and services.

The tools used for this task are designed to control the quantity of money and only that portion of it representing bank loans. However, the size of the money flow is determined not only by the quantity of money but by its rapidity of circulation, i. e., how often it changes hands. If the demand for goods and services rises faster than they can be produced, total purchasing power will expand as more and more checks are written against existing deposits. An increase in total spending proportionally greater than the increase in supply of goods means higher average prices, i. e., lower average purchasing power of the dollar. It is possible theoretically to counteract the effect of a higher rate of money turnover by actually decreasing the amount of bank credit, rather than merely putting a lid on further expansion, but this is difficult in practice. No one really knows until after the event that the trend in total spending has enough momentum to bring about inflation if continued. In recent months, price indexes have continued to rise despite some decline in spending which reflects the fact that production (and employment) is being harder hit by the recession than purchasing power (wages plus transfer payments). If a recession merely means greater unemployment with no correction change in, or possibly even higher prices, we no longer can hope for price stability through monetary management, and the sooner we recognize this situation the better. We must have more exact information as to the reasons for the growing unresponsiveness of prices of goods, etc., to declining demand in the economy as a whole.

(*b*) The fiscal system of the United States is inadequate to the extent that specific spending and taxing programs may be (1) designed with narrow political ends in view rather than the needs of the people as a whole; and (2) adopted without adequate safeguards to assure minimum conflict during the life of the program with its proper economic objectives, and maximum coordination with monetary policies.

11. (*a*) If wage rates continue to rise during a period of declining demand, costs and therefore prices will continue to climb. There is less chance for an increase in the unit volume of sales to take place when prices remain high (or go higher) so that production is not stimulated. As production goes, so goes employment. Inflation through

higher wage costs, is therefore conducive to increased unemployment.

(*b*) Although full employment is desirable, inflation is potentially too dangerous to be acceptable as a means toward that end. We must attack the root causes of inflation: (1) faulty fiscal policy and (2) abuse of economic power by mass labor organizations. There is no proof that full employment and price stability are incompatible.

12. Debt plays a valuable and beneficial role in the economy but because its rate of growth inevitably tends to parallel that of business activity, it acts to widen the swing between boom and recession. When business is improving, namely, when sales, employment and incomes are advancing, new loans are contracted at an even more rapid pace, reinforcing the general upward momentum. When a downturn commences, and sales, production, and employment begin to decline, both lenders and borrowers exhibit greater caution toward incurrence of new debt, so there is less stimulus to spending from this source. Meanwhile repayments which have been growing with debt subtract a growing share of declining income so that the impact on sales is even more unfavorable than the actual decline in income would suggest.

13. Due to the necessarily imperfect workings of a large-scale economy such as ours, economic growth does not, and cannot be expected to, proceed at an even rate of advance, but occurs rather in a series of spurts to successively higher levels. Each peak period generates distortions, excessive inventory and debt burdens, higher labor costs and prices, and so forth, which ultimately require correction before further growth may be resumed. The process of correcting these imbalances involves curtailment of production, and therefore reduction of employment. We cannot reduce the need for economic adjustments of this type unless we act more vigorously to restrain the momentum of the upswing. Of course, we cannot afford to see our economy weakened for a prolonged period by widespread unemployment. However, Senator Douglas has estimated (in 1952) that a normal unemployment figure would be 6 percent of the work force. If this figure were to be used, Federal intervention would not be justified if unemployment should show no signs of exceeding it, or even if it should rise slightly higher for a period of a few months. Unfortunately there is less tendency to recognize an equally important obligation toward the same goal and purpose—the need for concerted action by the agencies of the Federal Government against the threat to stability posed by excessive spending, rising prices, and overemployment. This unbalanced conception of the role to be pursued by Government in rectifying the excesses of the business cycle will result in further cheapening of the dollar and will require increasingly larger doses of the remedies now being proposed.

14. During the 4 calender years 1952–55 the Federal Government pumped out nearly $10 billion more in cash payments than the amount of cash it took in from the public. More than half of this contribution to private purchasing power, $6.1 billion, was made during the single year 1953. In that year, the average percentage of unemployed in the labor force sank to the lowest point it has reached in the 12 years which have elapsed since 1945, while the average hourly pay rate for factory workers spurted ahead a little faster than in the year before or after. The high level of Federal spending for goods and services has in itself contributed to inflation since the type of goods

and services needed most were in competition with the booming sectors of private demand for raw materials, skilled manpower, and productive capacity.

15. Over the long run we can keep a larger proportion of our labor force at work by holding the purchasing power of the dollar steady, than by permitting it to decline. When wage rates rise faster than output per man-hour in general, consumer spending and business are stimulated for a time. The wage increases themselves are only part of the additional purchasing power created; the higher incomes of workers provide the basis for a further expansion of consumer and mortgage debt which helps to augment consumer spending still further.

The excessive wage increases, however, boost unit labor costs, and therefore prices. Debt expansion begins to slow down, and unit sales at higher price levels begin first to level off, then to decline, and reduced employment is the inevitable outcome.

16. Escalator provisions in wage or other contracts are dangerous and undesirable in that (*a*) the incomes of those not protected by such devices are hit even harder by loss of purchasing power due to higher prices; (*b*) those most guilty of causing inflation are shielded from its punitive effects (although this is at least partly a deception); and to that extent (*c*) public support of measures to fight inflation is weakened.

17. The present recession is primarily the result of a turn-around in inventory policy. When sales are ascending, production expands even more rapidly as individual producers compete for a larger share of the market. The resulting inventory buildup eventually reaches a point at which it is considered excessive in relation to the current flow of sales, particularly when sales begin to level off or to decline. Production is cut below the rate of shipments in the attempt to reduce costs of carrying inventories. The process may go too far in the other direction because business psychology may run to greater extremes than is warranted by the actual extent of sales decline. The drop in production and increased unemployment resulting therefrom tend, at least partially, to bring about the very condition which is feared—namely, less buying by consumers.

The inventory cycle was bound to reach a crest sooner or later. It was brought to a head by the sharp drop in orders for defense durable goods in the third quarter of 1957, capping earlier evidences of leveling off or decline in consumer and business demand for various types of durable goods.

The reduced demand for consumer durable goods was particularly evident in the case of automobiles. Consumer resistance to higher prices, lack of enthusiasm for the new models, and probable unwillingness to add to a record-high burden of installment debt, are all involved.

The curtailment of business spending for plant and equipment is even more important since the decline promises to continue into 1959 and will have a greater effect on total spending. This change was the result of an excess of productive capacity built up during the capital investment boom starting in 1955. Sales failed to match the growth in capacity, and profit margins began to take an unfavorable turn.

Modernization, replacement, and new product development are hopefully expected to cushion the decline.

Consumer purchasing power has held up quite well despite the increase in unemployment and reduction in working hours. Disposable personal income dropped only 1½ percent from the August 1957 peak to February 1958.

Payrolls in nonmanufacturing industries and Government have held quite steady and increase unemployment compensation payments have helped to offset the decline in factory worker's pay. Some sectors of the economy are expected to expand in 1958, including some of the service industries, State and local government spending, private construction other than industrial, and the defense goods industries. Inventory accumulation (even though modest) rather than liquidation may be seen by the second half, and there is a good chance that the inventory situation will constitute less of a drag on production in the second quarter of 1958 as compared to the first. In short, prospects point to business recovery in the second half of 1958 without emergency measures.

If this view of the business outlook is accepted, it should follow that, if Government action is at all necessary, it should be of such a nature as to produce its maximum psychological and financial effect as early as possible, tapering off after midyear. If it continues to exert an appreciable impact on economic activity very much later, it may accelerate the rate of economic recovery enough to initiate a new round of inflation. Of the various actions proposed, the President's plan for extension of unemployment compensation payments, the idea of a tax cut on a temporary basis, and the easing of home financing requirements and of credit generally, seem the most suitable.

GENERAL DYNAMICS CORP.,
New York, N. Y., May 7, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: In connection with the Senate Finance Committee's inquiry entitled "Investigation of the Financial Condition of the United States," you have asked that I submit my thoughts and opinions about vital matters affecting our economy.

Since your committee's study is "the first full-dress examination of our fiscal and monetary policies since the one conducted by the Aldrich Monetary Commission in 1908," its fruits will no doubt provide fresh insights into the delicate mechanisms of fiscal and monetary control and their effective application to the flexible and variable forces of private enterprise.

Events since your committee opened its hearings have underscored with disturbing impact the vital need to find solutions to the crucial problems which your committee is examining.

Some of the elements of our current recession are sufficiently unorthodox in their manifestations and tendencies as to have frustrated the efforts of most of us to predict with confidence its precise course or duration. Ending the recession without inducing a resumption of inflationary pressures involves possible contradictions which complicate immeasurably the process of applying vigorous remedial actions.

Analysis differ in the weight they ascribe to the various precipitating causes of the recession. It is encouraging, however, to note that increased emphasis is being given to the impact of governmental and industrial actions on the psychology of the consumer.

How serious was the psychological impact? The effect can be measured to some extent by the recently published survey of the National Bureau of Economic Research. The poll, taken in early April and covering 25,000 families representing all parts of the United States, reveals that the plans of this cross section of the public to buy new cars fell by 20 percent and to purchase major items of household goods by 10 percent, from October 1957 to April 1958. This result can be explained, perhaps, partly by overextension of personal debt, lack of product appeal, or unemployment, but I personally believe that a very substantial part of the answer lies in the disturbance of the consumers' confidence in his personal financial security or in the stability of the economy. If this appraisal is correct, the meaning cannot be ignored.

Perhaps the combination of circumstances which triggered off the recession were unavoidable—given the economic antecedents and the then existing framework—but to the extent that opportunity for choice existed, one lesson of the last 8 months would seem to be that both industry and the Government must learn to plan and schedule

their large-scale expenditure programs in such a way as to avoid, to the extent possible, the cutting off of both public and private spending abruptly and simultaneously. In the fall of 1957, business expenditures for plant and equipment were leveling off and planned programs indicated reduction of private investment expenditures for 1958. At the same time, the Government took rather drastic steps to curtail the rate and scale of defense expenditures. Since consumer purchases of automobiles and household equipment had already declined earlier in the year, and United States sales abroad had also declined, the impact was probably greater than most of us had anticipated.

One probable reason for failure to judge consumer psychology and economic trends with a higher degree of accuracy is that the methods of gathering and interpreting data on our economic forces are inadequate. The recently issued Rockefeller report on the United States economy suggests that an additional $5 million to $10 million a year devoted to the assembling of statistics indicating the state of the Nation's economic health would yield very high returns. Refinement and improvement of the techniques of handling economic intelligence should not be delayed.

The basic fiscal and monetary policies of the Nation contribute importantly to the mechanisms which determine the consumer's buying habits, wants, and satisfactions. Nevertheless, fiscal and monetary policies alone cannot serve as total regulators of our economy, particularly if, as now appears to be the case, their application does not necessarily reach wage-price relationships. It is to be hoped that this regulator can be supplied by self-restraint and mature judgment on the part of management and labor in our free society. For the prospect of a continued rise in costs and prices in the face of declining business activity and consumer resistance could prove serious. Although corporate profits are expected to decline in 1958 from approximately $41 billion to an estimated $36 billion or less, hourly wage rates are almost certain to advance because of wage increases written into existing contracts, to say nothing of the outcome of current labor negotiations in large industries.

But the Government is not powerless in this area, short of legislating a national policy. Congressional committees can be powerful instruments of enlightenment. What is needed is the development of a body of fact and opinion of such formidable import that false economic wage-price demands and practices will fall before the weight of enlightened public opinion. If, for example, support of the prewar purchasing-power theory of wages is demonstrably the major cause of the upward push of wages and prices, the case should be fully documented and disseminated. The same holds for the theory of expanding corporate profits as the cause of inflation.

The many experts upon whom you have called will unquestionably provide significant opinions on the technical aspects of fiscal and monetary policy. I would like, therefore, to offer a few comments on a facet of the problem which perhaps may not receive adequate discussion: the relation of fiscal and monetary policy to security expenditures.

In the fateful struggle between Russian militant imperialism and United States defensive resistance, there are several ways by which we can forfeit the victory. The most obvious and certain way is to

let the balance of military power and prestige swing in Russia's favor. A less obvious, but interrelated way, is to fail to meet and counterbalance the cultural and economic offensive of Russia in all parts of the Free World. A third way is to tolerate a weakening of our economic strength to the point where we cannot effectively cope with the first two dangers.

As the cold war intensifies, and the cost of waging it multiplies, the balancing of the risk of endangering our economic system by reason of astronomical expenditures against the risk of imposing arbitrary ceilings on our defense effort for fiscal reasons becomes a formidable dilemma. The extent to which military programs should be cut back, stretched out, or eliminated for fiscal or economic reasons is fundamental. The extent to which security expenditures should be used as economic regulators should be more clearly examined and understood. And the true impact of security expenditures on our economy—favorable as well as unfavorable—must be put in proper perspective.

With respect to use of security spending as an economic regulator, Prof. John Kenneth Galbraith has recently expressed the following view:

"* * * military outlays should be established wholly by need and not at all by fiscal considerations. This is an ironclad rule.

"To adjust military spending to the fiscal needs of the economy is both reckless and immoral. It is reckless because it means that such expenditures will then be cut, regardless of urgency, whenever inflation threatens. And it is immoral because it means that outlays for these instruments of death would be increased regardless of need when there was unemployment and idle capacity.

"There has already in these last few weeks been far too much ill-considered talk about defense expenditures as the new form of pump-priming.

"I don't suppose there is any aspect of Communist propaganda that has made so much headway as the conviction in some way that the American economy is dependent on arms expenditures. It is a charge that we should most scrupulously and honestly avoid * * *."

A somewhat modified view of this principle is contained in the statement of the Committee for Economic Development, Antirecession Policy for 1958, issued in March 1958, at page 18:

"The size and character of the defense program should be determined solely by considerations of national security. It would not violate this principle, however, for procurement scheduled for a year or two ahead to be rescheduled to support incomes and employment when such support is needed. The danger of obsolescence and the long lead times required for many items limit the extent to which this can be done, but some significant support to the economy should be possible. Continued procurement of items that are no longer needed, merely because this is the easiest way to place contracts and obtain production quickly, must be guarded against."

I recognize, of course, that there are limits to the amount of expenditures which can be made, even for security, within the framework of a free society and a free-enterprise system. But, as a principle, the defense program, in my view, should be formulated and effectuated on the basis of need and not as a part of those Federal spending processes which can be adjusted flexibly to meet or further fiscal requirements. It should not be looked upon as a contracyclical device,

for the volume of security expenditures is too sensitive to international pressures and tensions. Dependence upon them as basic tools to promote economic stability would appear to make neither good economic sense nor sound military sense.

Another consideration which should be weighed in determining the relation of fiscal policies to defense expenditures is the nature and extent of the impact of such expenditures on the economy. While security spending can be justified only on the basis of security needs, the effects of such expenditures on our economy must nevertheless be appraised realistically. The matter deserves our closest attention, for the rate and scale of our security effort should not be artificially limited by false or questionable economic assumptions. The risk of a mistake here is too great. Considering the lead time required to develop and manufacture tomorrow's weapons, there may be no recoupment of the advantage we yield today. Therefore, it is important to know whether defense spending is destructive to the economy, or if, in fact—as many economists believe—it has raised the realized rate of growth since 1939 and played a decisive role in revolutionizing research, development, and technology since 1940. Similarly, it is essential that we study the longer range implications of defense spending, as respects the possible diversion of resources from the civilian economy, the positive or negative effect of such spending on other segments of the economy, and the increasingly serious competition for sources of revenue. In this connection, the studies reported under chapter VIII, page 507, of the volume issued on November 5, 1957, by the Joint Economic Committee, entitled "Federal Expenditure Policy for Economic Growth and Stability," provide some stimulating and illuminating observations.

Interrelated with the question of defense expenditures is the matter of furthering the economic health and development of our friends and allies. Here is an area where aggressive action by the Government in establishing favorable conditions for investment and equally positive action by industry to expand foreign investment, could, at one stroke, help stimulate the economy and achieve incalculable benefits in international relations. While the encouragement of expansion of international trade does not at first blush appear to be a significant means of stimulating the economy, there is evidence that a relatively small advance in this area could go a long way. Increased effort must in any event be exerted sooner or later, forced, perhaps, again, by Russian example. With long-term loans at low interest rates, the Soviet bloc has doubled its trade with the less developed nations in 3 years from $840 million in 1954 to about $1.7 billion in 1957; and the number of trade agreements in this 3-year period has leaped from 49 to 147. We would be well advised, in my opinion, to address ourselves to an accelerated offensive on the international trade front. The mechanisms of credit and risk insurance, supported by policies which would encourage foreign trade, could open stimulating new frontiers for American industrial development abroad.

In general, monetary and fiscal policies appear to have the flexibility intended for them, but they cannot, in and of themselves, maintain a perfect equilibrium in our economy or provide complete stability. As Federal Reserve Board Chairman William McChesney Martin told your committee on April 22:

"By fostering conditions conducive to prosperity, the Government can help a lot. But it can't do it all. That is why the Employment Act of 1946 pledges the Government's efforts to create and maintain 'conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing and seeking to work.' And it is why the same act says the Government's efforts to that end shall be applied 'in a manner calculated to foster free competitive enterprise and the general welfare.'"

"Monetary policy is undertaking, within its inherent limitations, to provide such a climate for recovery. It is not omnipotent, but I can assure you that the System is approaching the problem of combating recession with just as much vigor as it exhibited in battling inflation."

The key to economic stability must necessarily lie in the power of industry to create new and permanent jobs in an expanding but secure economy. It seems to me that many areas of public and private policy should be reexamined with this fundamental objective in mind, such as: the area of taxation and its impact on incentive and initiative; the area of depreciation policies as they affect industry's ability to provide new resources for expansion and increased employment; the crucial relationship between the relative rigidity in the wage-price trend and the more flexible economic factors which are more responsive to changes in Federal monetary and fiscal policy.

There is an everincreasing awareness of these problems and the understanding of them will grow with the improvement of our techniques of economic intelligence. One formidable problem, as I see it, is to develop organizational techniques for the interpretation of economic indicators in a manner which will permit both the Government and industry to synchronize their planning in a more orderly and coordinated way than they now do.

Government and industry must develop more mature relations between each other, and each must reorganize itself in a manner so as to insure that the ultimate national policies which are important to the survival of the nation can be effectively applied by the Government cooperatively with industry. It must always be borne in mind that while Russia can make the national will felt almost by reflex action through its monolithic structure, the only possible exertion of Federal will in this country is through the coordinated effort of both the Federal Government and private industry. Not only our domestic economic life, but the whole defense effort and the prosecution of our foreign policy, necessarily involve industry as a partner of the Government, or at least as an essential instrument through which the Government's policy must be expressed.

The importance which I have attached to the relation of fiscal and monetary policy to security expenditures may suggest that this document is a self-serving one for the industry of which I am a part. You will appreciate, however, that my service in this industry has focused my attention sharply on this problem. The views which I have expressed in this letter represent my convictions.

I trust that the few observations I have made will serve the important deliberations of your committee.

Sincerely,

FRANK PACE, JR., *President.*

PHILADELPHIA ELECTRIC CO.,
Philadelphia Pa., March 31, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR: Your committee's investigation of the financial condition of the United States is a timely and desirable project. The following comments have been prepared with reference to the list of questions supplied by your letter of February 17, 1958. It has been a pleasure to take part in this project and it is hoped that these comments will be of value.

Price stability is an important segment of our free-enterprise system. Fluctuations of the economy resulting in periods of rising and falling prices, undermine the basic concepts of our economic system. While limited price variations within the various segments of industry do occur, they do not necessarily constitute inflation or deflation.

Economic growth in production, demand, and employment can continue as long as the supply of money, the demand for goods, and the ability to produce goods maintain a proportionate relationship. As soon as one of these factors is changed without a corresponding change in the others, the effects on price become apparent.

Since 1947 we have seen an erosion of the dollar which is continuing today. The monetary policy of the government and the economics of our free-enterprise system have each made their contribution to the inflationary potentials in our economy.

By pegging the interest rates on Government securities at a low rate during the period 1942–50, the Federal Reserve permitted the expansion of bank credit and money supply more rapidly than necessary for the rising physical volume of goods and services.

Following the accord with the Treasury in 1951, interest rates on Government securities were allowed to follow the free market. The reserve requirements of member banks were increased and the expansion of consumer credit was temporarily slowed. The fast action by the Reserve in 1953, when the reserve requirement was reduced, and in early 1954, when the discount rate was lowered, did much to make credit available for a fast recovery following the 1954 recession. Similarly, the tight money policy of the Reserve from 1955 until the end of last year has done much to contain the expansion of credit and the money supply.

These lessons have shown that restrictive credit policies are effective in stemming inflation, but their effectiveness as a stimulant to ward off deflation is questionable, because the mere price of credit is not the only determinant of its demand. The Federal Reserve should ease credit on the downswing as the market demands, but should remain alert to any resurgence of inflationary trends. It is its ability to act as a brake on the upswing of credit expansion which is the Reserve Board's major contribution to stability of growth in our economy.

There seems to be little question as to the adequacy of our banking system to meet the normal increase in credit expansion for the years ahead. Unfortunately, however, there is no definite measure of ascertaining the amount of credit expansion appropriate to a particular level of business activity. The sheer size of the consumer debt is often misleading. It seems that the relationship of extension of credit, repayment, and personal income might be the best indicators of the inflationary or deflationary pressures of this form of credit. As long as these grow at a relatively constant rate, there is no reason to believe the consumer debt is too large.

Prior to 1951, the Treasury's financing problems were eased by the ready market for its securities made by the Federal Reserve. It is now evident that this added to the inflationary trend. In retrospect, it seems that there should have been an attempt to lengthen the maturity of Federal debt in light of repeated warnings of the inflationary potentials. The higher interest rates which would have been incurred, seem small today.

Often sight is lost of the real effect of interest costs to the Federal Government. Much of the interest paid by the Treasury becomes income to other Government agencies, so that their requirements for other funds are reduced. Even now, lengthening the maturity of the debt seems to be the only way of relieving the strain of refunding during unfavorable periods. Most businessmen would consider it ill-advised to attempt to finance their capital needs through short-term loans, why then should the Government?

The rapid expansion of Federal, State and local spending, has contributed significantly to the inflationary pressures. High taxes have diverted funds into Government spending, which might otherwise have been removed from the money stream, and have reduced the effectiveness of credit restraints in varying degrees, depending upon the borrowers' tax bracket. During inflation the Government's tax bite increases as we move up the brackets of the tax ladder, thereby reducing purchasing power and the funds available for investment in increasing productivity. These funds are then used to purchase military hardware which does not add to productive capacity of the economy or become available for private consumption.

A stable dollar can best be achieved by a reduction in Federal expenditures and taxes. In this way a balanced budget would be maintained, thereby minimizing the effect of the Government's injections and leakages in the money stream. Spending of private enterprise is necessarily predicated upon a corresponding increase in productivity, so that the money supply and productivity relationship is affected only by a change in saving habit or an incomplete allowance for capital consumed, as has been the case in recent years. The increased funds required for replacement have not been allowed to accumulate, so that it has been necessary to use up savings and expand borrowing, thereby putting more money into the stream than might have otherwise been necessary. This factor will continue to exert inflationary pressure as long as a realistic approach to capital consumption is hindered by tax measures.

The economic controls inherent in our fiscal and monetary systems seem sufficient to maintain the continued growth of our economy without governmental control over the individual segments and enterprises. The banking system has the power to maintain credit structures, and

the Government can influence the economy by spending policies and tax moves. There seems to be no need for further controls over prices, wages, and other costs.

Some accusations of administered prices have been aimed at big industry, but experienced businessmen realize that in the end prices must conform to what the buyer will pay.

The effect of administered wages may be even more prevalent with the continuing increase of the power of unions, which is now far beyond that of any corporation. This may be the major reason why wages continue upward despite a downturn in business. Escalator clauses tend to perpetuate inflation, but the fact that they are not universal will in itself diminish their effect in time. Regardless, the economics of supply and demand will in time control these features without Government intervention, and without the necessary imbalances to free competition.

The seeming paradox of inflation and unemployment may reflect pricing policies, but as has already been seen in many industries, these practices should right themselves in a free market. Control over such basic factors of our economy would endanger the free-enterprise system.

The use of large increases in public works may be effective as a pump primer in times of a serious depression, but would be of little effect during the present period. There has been no recession in which construction activity has ben the major force of resurgence, in fact, in the past business has been turned up prior to capital spending.

This poses the problem as to when pump priming and tax cuts are effective. Tax cuts have been the more effective means of putting money into the stream quickly and efficiently. In 1954 it took less than 2 years for tax revenues to exceed those prior to the cuts. Tax cuts also can be remanded if inflation again threatens. Public works are long term in nature and usually affect the economy long past the time required for pump priming, thereby adding to the resultant inflationary forces. Also it may be harder to raise the extra funds required to balance the budget because of the delay from the time these funds are put into the economy until they are received as taxes.

Certainly in a recession of the magnitude we are now experiencing, a large public works program would kindle the fires of inflation and might be more difficult to control once underway than the effects of a tax cut of similar proportion.

The effectiveness of public works should not be ruled out, but this is a weapon which should be retained for extreme cases such as the depression in the thirties.

Our present economic recession stems from an oversupply of goods created by overinvestment in facilities without a corresponding increase in the demand for goods. The high inventory situations of many of our basic industries have been accumulated as a result of overspeculative production. The policies of tight money and economy in Government, which were so prevalent about a year ago, have caused many people to reevaluate their expansion plans. Those that were founded on speculation have been canceled and many people looked for other means of financing their working positions. Large inventories, especially in the durable goods industries, became an easy source of working capital. The same psychological factor had its effect on consumers also. They took a wait-and-see attitude based on the fact

that their essential needs were well satisfied. Then the added effect of the resurgence of Soviet science added to this loss of confidence. All this led to inventory liquidation, a slowdown in production and employment, and finally increased unemployment and pressure on prices.

During all this, the loosening of credit by the Federal Reserve will probably have little effect because people who needed new facilities continued to build regardless of interest rates. It was only marginal expansion that was stopped.

The greatest weapon available to stabilize the economy today is psychological. If the confidence of the consumer can be regained, the necessary cash and credit are available to restore economic growth. The utility industry has the greatest confidence that this will happen in time as is evidenced by the continued expansion of facilities in order to meet the needs of the years ahead.

It would seem that economic stability can be achieved now in much the same way as in 1954—namely through the reduction of Federal expenditures, taxes and an easing of credit restrictions. Recognition should be given to the deterrent effects of taxes on business as well as the consumer. The reduction of corporate taxes could bring some relief to the need for funds in the money market. Business would better be able to absorb cost increases, thereby passing much of the benefit on to the consumers. The stabilizing effect of prices would stop the rise in the cost of living, and the inflationary effects of escalator cost increases. Individual income-tax reduction would immediately put more funds in the hands of the consumer, some of which in turn might be used to make purchases now delayed.

Certainly, one of our greatest fears still is inflation and any fiscal tampering must be careful not to upset the delicate balance of money supply and productivity. We must be alert to any indication of continued inflation in order to break the vicious circle of creeping inflation.

Stability of the dollar can be realized only through the exertion of economic and political wisdom and courage.

Very truly yours,

R. G. Rinclife.

THE FIRST NATIONAL CITY
BANK OF NEW YORK,
New York, N. Y., March 7, 1958.

HON. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate,
Washington, D. C.

DEAR SENATOR BYRD: This is in reply to your letter of February 17, enclosing 17 questions and requesting my opinions on the matters covered. The questions are extremely broad. To deal with them in a fully comprehensive way, it would be necessary to write a book. Therefore, I should like to take advantage of the suggestion in your covering letter and, rather than attempt to answer each question in detail, use them as a guide for general observations on the issues raised.

Several of the questions deal with inflation, deflation, full employment, etc. A national economic policy must have twin objectives. On the one hand, it should be aimed at promoting growth in the economy to provide for national security and rising standards of living and welfare. At the same time, it should also have price stability as a goal. Price stability insures that the gains of growth are enjoyed by all, not merely by those who bargaining power is greatest. There is also real question whether the sound and sustained growth we need is possible in an inflationary environment. Inflation is not merely inequitable; it also, as economists have long recognized, leads to inefficiencies and misallocations of resources which reduce the economy's real rate of growth. It creates an atmosphere in which speculators thrive better than producers. We need to recognize, as we have not fully done, that inflation is as objectionable as deflation. I therefore suggest that the declaration of policy in the Employment Act of 1946, which is the stated guide to national economic policy, should be reworded and price stability specifically named as a goal of policy, coordinate with maximum employment, production, and purchasing power. I would answer question 11 (b) in the negative.

It follows from the above that I believe monetary policy, like other Government economic policies, should seek to attain both economic growth and price stability. I believe monetary policy has pursued these objectives in a generally commendable manner, at least since the Treasury-Federal Reserve Accord in 1951 freed the Federal Reserve of necessity to support prices of United States Treasury obligations. I believe the Federal Reserve System should continue to enjoy the same degree of independence in action that it has had since 1951.

Monetary policy should be flexible. It is most effective when restraint is called for, in checking boom excesses which historically have brought painful deflation as an aftermath. The effects of an easing policy, in the converse circumstances, are less certain and less pronounced; however, monetary ease in recession obviously has an impact on the ability of lenders to make credit available and on credit supply.

It doubtless has some stimulative effect on borrowers' credit demands. Flexible monetary policy promotes stability, within the framework of growth.

Monetary policy cannot do everything, of course, as the recent rising course of consumer prices in a period of credit restrain suggests. While some of the price rise reflects belated adjustments of the prices of services to earlier inflationary pressures, the major responsibility seems to lie in the area of wage and labor policy and Federal budget policy. However, the inflationary experience would have been worse if monetary policy had not been one of restraint.

Monetary policy has been hampered not only by wage policy but by the renewed upward trend in Federal spending. A lower level of spending and larger Federal budget surpluses would have permitted more debt retirement, releasing existing funds for private use. It would also have reduced the frequency with which the Treasury has come to the money market for new money or to refinance maturities, each time influencing if not requiring the Federal Reserve temporarily to moderate its restrictive credit policy. Recent Treasury funding operations to improve the maturity structure of the public debt are helping to relieve the weight of early maturities which have proved an impediment to the enforcement of a restrictive Federal Reserve credit policy.

Federal, State, and local government spending is just as inflationary as any other spending. In fact, many authorities, including Arthur F. Burns, former Chairman of the President's Council of Economic Advisers, say Government expenditures are more inflationary than private expenditures. Dr. Burns observes that Federal Government officials, by and large, are probably less efficient shoppers than private citizens, buy a good deal on a cost-plus basis, and are required to include special provisions regarding wages and other labor standards in the contracts they negotiate. He points out that their outlays, which nowadays are of necessity heavily concentrated on national defense, seem unlikely to contribute to the improvement of industrial capacity and productivity as would private expenditures of the same magnitude. In addition, Dr. Burns has warned that balancing expenditures by increased taxation does not necessarily cancel out the inflationary impact, for private spending need not be reduced by the amount of the tax increase. People may instead cut their savings in order to maintain their consumption, at least in part.

At the same time big Government spending leads to excessive taxation which, as more and more people are recognizing, has inflationary and other harmful effects of its own. It is siphoning away badly needed savings which could finance industrial growth, most particularly from small business which needs it most. Meanwhile our severe personal income tax rates are making it less attractive to gifted individuals to put out the extra effort needed to go ahead and succeed. We need to remember that in our type of society, depending on individual effort and initiative, we stifle the rewards and compensations at the risk of reducing performance. This is something we cannot afford in the face of the Soviet Union's challenge for world military and economic leadership.

The United States monetary system is currently financing gross national production well beyond $400 billion. Nevertheless, questions of adequacy and possible weakness have been raised with increasing frequency in recent years as the economy has developed novel and ingenious methods of economizing on and supplementing the available bank deposit supply. The growth of unregulated lending outside the banks and the creation of near equivalents to money by nonbank financial intermediaries are cases in point. We feel that these and numerous other changes since the Federal Reserve Act of 1913, and even since the financial reform legislation of 1933–35, call for a detailed, technical study of the United States monetary system. Accordingly, we endorse the Committee for Economic Development's projected National Commission on Money and Credit to make a "broad 3-year inquiry into the public and private monetary and credit policy of the United States."

Full employment and price stability are theoretically compatible. But in practice it is very hard to hold prices stable if full employment is misinterpreted to mean that we should never have more than an insignificant number of people temporarily between jobs or on seasonal layoffs. Trying to live up to this definition leads to overemployment, and the experience abroad as well as here is that overemployment brings shrinkage in the buying power of the currency.

The current recession is a natural reaction to an overexuberant boom. While it is wise policy to carry out necessary Government works in a time of reduced private demands (and conversely to defer public works during a boom), I believe that made-work projects are no cure for recession and should be avoided. They are likely to contribute to subsequent resumption of inflation. Larger public spending to counter recession would raise the specter of even higher taxes later. The fact is that the most promising way to stimulate business is to relieve the tax rates which are most constrictive of enterprise.

For the longer run it would be desirable to pass the Sadlak-Herlong bill which would reform the income tax structure over a 5-year period and culminate with a rate schedule running from 15 to 42 percent for individuals and a 42 percent rate for corporations. Both in terms of combating recession and furthering our long-range growth, it is doubtful if there is any other action Congress could take that would so brighten the economic outlook and revitalize efforts to produce and sell and go ahead with the creation of higher standards of living. Along with this, of course, should go strict economy to prevent deficits in prosperous times, when stability is best served by Treasury surpluses, debt reduction, and lengthening of the debt.

Very sincerely,

JAMES S. ROCKEFELLER.

AMERICAN AIRLINES,
New York, N. Y., March 31, 1958.

Senator HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: In response to your letter of February 17 I am glad to enclose herewith a statement concerning our views on the national economy.

Sincerely yours,

C. R. SMITH, *President.*

1. Definition of "inflation" and "deflation." There are just about as many definitions of inflation and deflation as there are economists to define these terms—monetary inflation, wage inflation, cost-push, demand-pull, and so on. The plethora of definitions arises largely from the temptation to define inflation and deflation in terms of causes rather than effects. No matter what the causes, all forms of inflation are reflected in a broad upward movement in prices, and all forms of deflation are reflected in a corresponding broad decline. We therefore define inflation as a general rise in the price level and deflation as a general fall.

There still remain the problems of selecting the stage or level of the economy at which prices are to be measured (spot markets, wholesale markets, retail markets, etc.), and the technique or yardstick to be used in this measurement. In our own company, we customarily use the consumer price index of the Bureau of Labor Statistics to measure inflationary price changes, since this index reflects the aggregate behavior of a broad range of consumer goods and services and has broad geographic coverage. In the final analysis, all of us, as consumers, are vitally affected by the prices of goods and services in retail markets. The BLS index is the most comprehensive measure available of the prices paid for consumer goods at retail.

2. Measures for avoiding inflation and deflation and suggested legislation: Inflation (a broad upward movement of consumer prices) normally occurs when the aggregate effective demand for goods and services (demand backed by money) exceeds the capacity of the economy to produce these goods and services. Conversely, deflation normally occurs when the capacity to produce exceeds the effective demand.

History teaches us us that most of the great postwar inflations have occurred after the money supply has been swollen by wartime deficit financing, and when the demand for consumer goods and services, pent up by wartime shortages, exceeds the capacity of the economy to produce at full employment levels. Under such circumstances, prices of both producer and consumer goods are bid upward, thus touching off the familiar cost-price spiral.

It is always tempting to legislate against inflation, as, for example, by amending the Employment Act of 1946, to make it the stated policy

of Government to maintain stable prices at full employment levels. Something useful might be accomplished in this way, particularly in situations where there might otherwise be some confusion as to what the objectives of Government economic policy should be.

Fundamentally, however, the problem of controlling inflation and deflation is administrative rather than legislative—that is, of finding out exactly what to do and the most effective way to do it. To put the matter differently, the basic problem is to determine some workable arrangement for maintaining the delicate balances between aggregate effective demand on the one hand, and on the other hand, the capacity of the Nation to meet this aggregate demand at full employment levels.

Both from the practical and theoretical points of view, the achievement of full employment and stable prices is clearly not easy, and no general rules can be laid down that would be effective under all circumstances. At what level, for example, does full employment verge upon over-full employment, so that there is an upward pressure through wages and the prices of producers goods on costs and thence consumer prices? And is it possible, except by inflationary deficit financing or successive doses of easy money, to maintain aggregate demand at full employment levels? The experts do not agree on these matters, partly, perhaps, because we have had no concrete experience with a system in which the dual objectives of national economic policy are to avoid the ravages of inflation and the social and economic wastes of unemployment. Such a system, in my opinion, is certainly worth a fair trial, with or without additional Federal legislation.

Government expenditures now represent so large a share of gross national product, and such expenditures have varied so erratically and unpredictably in the postwar period, that the problem of maintaining full employment with stable prices should be attacked first at the Federal level. Such a program might perhaps be implemented through a steering committee at the Cabinet or near Cabinet level, comprised of representatives of all departments and agencies whose activities have a major impact on Government expenditures and their financing. In the absence of any coordinated control of these activities, Government programs to achieve this or that objective, no matter how desirable they may be in their own right, may be largely self-defeating as they relate to the dual objectives of full employment and stable prices. For example, one of the principal factors underlying the steady rise of the Consumer Price Index in recent years has been the sharp recovery in agricultural prices, and the upward spiral of prices of construction materials and costs. Such an inflation clearly cannot be brought under control by the Federal Reserve authorities acting alone, when the avowed purpose of major Government spending programs (such as agricultural price maintenance, slum clearance and public housing, the highway program, etc.) is to overcome the effects of monetary stringency in many areas. Or again, when the economy has shifted into the downward phase of the business cycle, easy money induced by the monetary authorities can be largely offset in the capital markets, by a funding of short-dated bills and notes into long-term Treasury bonds. A coordinated program is essential if we are to achieve full employment and stable prices. Therefore we propose (1) that the objectives of national economic policy be clarified to emphasize price stability along with full employment, and (2) that a committee be established

to determine appropriate instruments to achieve these goals and to coordinate Government activities bearing upon them.

3. Monetary policy, 1942–57: Federal Reserve policy in the period 1942–57 can be divided conveniently into three sub-periods: 1942–46, the period of wartime emergency; 1947–51, the postwar aftermath in which Federal Reserve policy was inoperative owing to the pegging of the yield-maturity curve on Treasury obligations; and March, 1951–57, the period following the Treasury-Federal Reserve monetary accord, when monetary policy was restored to its proper role as a contracyclical force.

During the war emergency, prices of Government securities of all maturities were pegged to maintain orderly market conditions at a time when the Treasury was coming to market almost daily to finance the war effort. Generally, that policy appears to have been appropriate, although it would have been desirable if a larger portion of war expenditures had been financed through taxation rather than through deficit financing. That, however, was an error in fiscal policy, rather than in the policy pursued by the monetary authorities.

The crucial mistake was made in continuing the wartime pegging of interest rates until the monetary accord of 1951. Commodity prices rose rapidly in the immediate postwar period for reasons outlined in our answer to question 2, and monetary restraint was clearly called for to combat price inflation. Instead, the entire Federal debt was monetized (i. e., became the equivalent of bank reserves) by the policy of pegging the prices of Government securities of all maturities.

In the third of the periods mentioned above Federal Reserve policy was restored to normalcy. Monetary controls gradually became more restrictive up to the turning point of business in May 1953, were relaxed during the business recession of 1953–54, reverted gradually to a policy of monetary restraint until November 1957, and then gradually turned toward the side of ease during the current recessionary phase of the business cycle.

On the whole, monetary policy since March 1951 has been excellent, although with the advantage of hindsight it is possible to criticize minor details. Thus monetary policy may have veered too much to the side of active ease in 1953–54 than now appears to have been desirable in view of the subsequent rise in commodity prices. Conversely, the transition to the side of ease during the business downturn beginning in 1957 seems to have been rather hesitant, in the light of the depth of the current business recession. But these are comparatively minor matters of judgment and timing, on which even the experts disagree. On the whole, Federal Reserve monetary policy since March 1951 has been forthright and courageous, and the general results have been good.

4. Causes of the rise in consumer prices, August 1956–September 1957: The principal causes of the rise in the Consumer Price Index after August 1956 were (1) a "catching up" in the prices of services, rents, and transportation, which had been held down during the early postwar period by long-term contracts, Government regulation, and, to some extent, by custom (e. g., doctors' fees, etc.); (2) the resumption of agricultural price inflation under price-support programs of the Federal Government; (3) the wage-cost-price push (see the answer to question 2 above), resulting from over-full employment

(partly caused by Federal efforts to stimulate housing, road building, etc. at a time when private demand was more than sufficient to maintain full employment). Additional contributing factors were the strong consumer demand for goods and services, the efforts on the part of business to meet this demand by stepping up plant and equipment spending, and the concomitant rise in business inventories, which came on top of an economy already fully employed in the production of final goods and services.

5. Effects of debt management on the United States economy: In theory, debt management (defined here as adjustments in the maturity structure of the Federal debt rather than in its level) can play an important role in amplifying the effects of monetary policy. For example, in a period of monetary ease, when it is desired to encourage business investment and to expand the money supply, the indicated policy is for the Treasury to confine its financing to the short-term market by sale of short-dated bills and notes to commercial banks, the reserves to be provided for this purpose by the Federal Reserve authorities. The money supply is thus inflated (or a contraction prevented), and all of the funds flowing through the long-term market are thus made available to finance permanent capital expenditures such as housing, plant and equipment outlays, and so forth. Conversely, when business is booming, debt management can amplify restrictive monetary policy by a funding of short-dated Treasury obligations into long-term bonds, the bank reserves released by this process being mopped up by appropriate Reserve bank action. Under such circumstances, long-term funds which otherwise would be used to swell capital expenditures are, in effect, employed to reduce bank credit and to contract the money supply.

Thus, properly oriented monetary and debt-management policies are highly desirable. In practice, however, proper orientation is difficult to achieve since other objectives are allowed to intrude, thus mitigating or offsetting the effects of monetary policy. The recent issues of 3½- and 3-percent long-term bonds are cases in point. Since November 1957, the Federal Reserve has sought to ease conditions in the short-term market, while the issuance of long-term bonds by the Treasury in effect has tightened up the capital market. Earlier, when a restrictive monetary policy was called for to combat inflation, the level of bond yields appeared to the Treasury to be too high to permit long-term bond financing. The absence of long-term Treasury financing from mid-1955 to September 1957 illustrates the difficulty of effectively integrating monetary and debt-management policies in a period when bond yields are high.

6. Relative importance of price stability and economic growth: Of the three objectives of monetary policy mentioned in question 6—(1) price stability; (2) stability of production, demand, and employment; and (3) economic growth—the second is clearly inadmissible and can be rejected at once. Normal growth in our population and labor force implies growth in production, demand, and employment, unless we are to have rising unemployment, and a declining standard of living, which in the end would be incompatible with our free enterprise system. Growth in production, demand, and employment must therefore be the paramount goal of economic policy. A second goal—only slightly less important than the first—is to achieve growth with price stability. Price inflation in the postwar period has robbed many

of the more efficient and hard wording of our people of the fruits of their labor. As suggested in our answer to question 4, price inflation has also distorted normal price relationships throughout the economy, favoring sectors where prices are free to move upward at the expense of others where prices are fixed by long-term contract, custom, or Government authority.

In the last 2 or 3 years, the economy may best be characterized as one in which all sectors—the consumer, business, and Government—were trying to accomplish too much at once. Aggregate effective demand exceeded the capacity of the Nation to produce, and prices moved upward under the pressure of rising labor costs and expanding final demand. It is unfortunate that major Government projects such as the Federal roadbuilding program that were initiated to combat the mild business recession of 1953–54 contributed importantly to the price inflation of the boom years 1956–57.

7 and 8. Effects on the economy of Government spending and taxation: Government spending and taxing are two sides of the same coin; both involve a transfer of control over the limited resources of the economy from the individual to Government. Although many forms of Government spending may be highly desirable to achieve various social goals, the basic functions of Government are very simple and should be narrowly circumscribed. It is too often lost sight of that the basic Government functions are only two in number: (1) to govern and (2) to protect the individual. All other functions should be examined carefully to see that they do not infringe upon the individual's right of free choice in spending his income, and do not stifle initiative and efficiency through burdensome taxation.

All of this assumes, of course, that the individual is wiser than Government in deciding how he should best spend his income. On occasion there are overriding circumstances that might warrant Government interventon to prevent the free choice of individuals in the market place from directing the allocation of the Nation's resources to the most efficient uses. In the absence of such overriding considerations, Government spending (and taxing) should be kept to a minimum.

9. Role of fiscal and monetary policy in combating inflation and deflation: Fiscal policies relate to the activities of the Treasury (on the side of Government receipts, expenditures, and debt management) to maintain full employment and stable prices, whereas monetary and credit policies pertain to the activities of the central bank (the Federal Reserve System) to achieve the same ends.

According to textbook theory, appropriate fiscal policy under inflationary condition calls for a decrease in Government expenditures and an increase in Government receipts (tax and other revenues), with a resulting rise in the Treasury cash balance and a correlated decline in Federal debt. A decrease in Government expenditures results in a direct curtailment of aggregate effective demand for goods and services (the basic cause of inflation; see question 1 above); an increase in Government receipts through higher taxes, and so forth, results in an indirect decrease in aggregate effective demand through drains on disposable personal income and the net cash flow to business corporations. The related rise in the Treasury cash balance, and decline in Federal debt, are also deflationary, to the extent that liquid bal-

ances in the private sector of the economy are thereby reduced (here we include Government securities with cash as part of the liquid balances of the community). The converse policies are appropriate during deflation.

Restrictive monetary policy during inflation acts to reduce the availability of bank credit (and hence restricts the growth in money supply), thereby also reducing aggregate effective demand for goods and services. Restrictive monetary policy is, of course, most effective when supplemented and supported by fiscal policy. And conversely, the two policies—monetary and fiscal—can play an important role under deflationary conditions by checking the decline in aggregate effective demand.

From a practical point of view, the two policies are seldom geared to work together efficiently. For example, an increase in Government expenditures designed to check a deflationary trend usually lags well behind that trend. Thus, Government expenditures frequently rise when the business curve is rising and fall when it is falling, in exactly the opposite fashion to that indicated by the textbook theory of appropriate fiscal policy to combat booms and depressions. This means, in effect, that the only operational policy that we can rely upon to check booms and depressions is that exercised by the monetary authorities. The reasons are largely political, and result partly from the quasi-independent status of central banking in this country.

(10) Adequacies and inadequacies of monetary and fiscal systems in the United States: The adequacies and inadequacies of our monetary and fiscal systems have been touched upon in the answer to question 9. Theoretically, both are sufficiently adaptable and flexible to play an important role in combating inflation or deflation; practically, only one of these systems—the monetary system—can be relied upon to act in the appropriate way.

On the whole, our monetary system—particularly the quasi-independent political status of the central bank—seems to me to be efficiently designed to provide industry with needed bank credit, and to provide it in such amounts and at such times as to reduce inflationary and deflationary pressures. Recent experience suggests, however, that monetary policy alone is unequal to the task of maintaining full employment and stable prices. At times, excesses develop in the monetary and credit field, such, for example, as the expansion in mortgage loans and consumer credit in the 1955–56 boom. When excesses of this type appear in the credit structure it would appear desirable if selective credit controls could be instituted and coordinated with general monetary policy.

More important, however, the fiscal activities of the Government are now so large, and occupy such an important place in the economic framework of our country, that concerted effort should be made to see that activities in this broad area do not subvert monetary policy. We should, however, not lose sight of the problems that may arise from a coordinated effort to control inflation. One of the principal dangers of coordinated fiscal and monetary policy is that the Federal Reserve System might lose its independent status and might, through political pressures, be prevented from taking appropriate action to stabilize the price level. Coordinated effort is essential if we are ever to achieve the dual goals of full employment and stable prices.

In the process, however, the independence of the Federal Reserve System must not be undermined. An independent monetary authority is our principal bulwark against galoping inflation.

11. The Paradox of Inflation Amidst Unemployment: (*a*) The so-called paradox of inflation with unemployment is more apparent than real. It arises partially from the fact that the Consumer Price Index of the Bureau of Labor Statistics is a lagging indicator of price inflation. As a general rule, spot commodity prices begin to fall well before business generally turns down. In the price complex, spot prices lead wholesale prices, which in turn lead prices in retail markets. Only after unemployment has risen for some time and personal income has turned down is there a final response of consumer prices to lagging consumer demand.

Other factors besides the level of employment also play an important role in the behavior of the consumer price index. Agricultural price supports, for example, prevent food prices from adjusting freely to changes in consumer demand. Monopolistic practices in trade, unions and in business also prevent prices in some areas from adjusting promptly on the downside to declining demand. Even the weather plays an important role in determining the direction of consumer prices—for example, the recent Florida freeze which resulted in higher prices for fresh fruits and vegetables. And there are other factors too numerous to mention. Some prices can respond promptly to changes in demand, while other prices—held down artifically by law, custom, or long-term contract—may continue to creep upward toward proper alignment with general prices and costs well after the more flexible prices have begun to move downward. The lack of balance in the price structure produced by an inflationary spiral—and the resulting upward drift in some prices after others have turned down—is largely responsible for the current paradox of unemployment with price inflation.

(*b*) The desirability (or inevitability) of creeping inflation as a device for maintaining full employment is a matter about which much has been written, but on which there is little evidence that might serve as a useful guide. The question is much too complex to be settled on the basis of the simplifying assumptions in vogue among those who are convinced they know the answer to this question.

As has been suggested in our answer to question 2, the problem is very complicated and is based partly on economic, partly on political, and partly on administrative considerations. In the final analysis the matter boils down to finding some workable administrative arrangement that would give practical content to the dual goals of full employment and stable prices. Until a concerted effort has been made in this direction, and until we have an historical record of experience with an economy directed towards achieving these two goals, no one can answer the question of whether price inflation is desirable (or necessary) to maintain full employment. In the present state of our knowledge, there is no reason to believe that price stability and moderately full employment are incompatible goals. Although we lack experience, both objectives are highly desirable. The system should be given a fair trial.

12. The threat of private indebtedness to economic stability and vitality: No conclusive evidence exists that the growth in private

indebtedness in the postwar period, or its present level, has created a threat to our economic stability and vitality. Asset values, equities, and income have grown roughly in proportion to indebtedness in the private sector of the economy. Because of the contractual nature of debt repayment, private indebtedness may become burdensome in the future, but only if there were a sharp deflation of income and values. Indebtedness, per se, is not a threat to economic stability and vitality, although it can seriously complicate the problems of economic adjustment in the event of a deflationary spiral.

To reduce the likelihood of complications arising from the contractual nature of debt service in the future, consideration should be given to maladjustments in our tax structure that favor debt over equity financing. An obvious step in the right direction would be to eliminate the double taxation of corporate dividends under the present Federal corporate income tax—to treat dividends paid by business corporations as deductible for tax purposes, just as interest on debt is now treated as a deductible expense. Similarly, in the case of mortgages secured by residential properties, attention might be given to tax revisions that would permit a home owner to deduct a portion of his equity in real properties, just as he is now permitted to deduct interest as an expense. Such measures would stimulate equity financing as against debt, and would thus help in maintaining balance in the financial structure of the private sector of our economy. But the principal protection against dislocations arising from debt liquidation is to maintain a level of asset values and incomes commensurate with the existing level of debt. Provided we can achieve dynamic economic growth, with full employment and stable prices, the current level of indebtedness will not be a threat to economic stability and vitality.

13. Statistical guides for fiscal policy: It is difficult to lay down hard and fast rules as to when tax cuts and public works should be introduced to combat a downturn in the economy. So much depends upon the behavior of different sectors of the economy that it is impossible to set up precise standards as to when fiscal action is needed to offset adverse business trends.

As a rough guide (subject, unfortunately, to amendments too numerous to mention), unemployment is a key indicator of the existence of unutilized capacity, manpower, and resources in our economy. When the seasonally adjusted rate of unemployment (unemployment expressed as a percent of the civilian labor force) rises above, say, 6 percent, consideration should be given to tax reduction as a first step in alleviating economic distress. And conversely, when the seasonally adjusted rate of unemployment falls below, say, 4 percent, attention should be given to tax increases and to the curtailment of postponable public works, in an effort to prevent an inflationary wage-cost-price spiral that might otherwise arise under conditions of over-full employment.

Unfortunately, the rate of unemployment alone provides little information on the direction of change in business activity. Action might be called for if unemployment were rising above 6 percent, with reasonably firm expectations that the unemployment rate would continue to increase, but would certainly not be called for if unemployment were temporarily above the 6 percent level, and if business were improving so that it could be reasonably assumed that unem-

ployment would soon decrease. Unemployment is a lagging indicator of the direction of change in business activity. Various leading indicators, such as hours worked per week and other series selected by the National Bureau of Economic Research, provide useful information on what the future holds in store.

14. Federal deficit spending as a cause of inflation since World War II: Since World War II (roughly the period spanned by the Federal fiscal years 1947–57) the aggregate deficit in the Federal budget was $9.7 billion, most of which was incurred during the Korean war. Over the same period, the increase in gross Federal public debt was only $0.7 billion. Although large in absolute terms, these figures are small in an economy with a gross national product running well in excess of $400 billion per annum. On the whole, therefore, Federal deficit spending has been a minor factor in contributing to inflation in the postwar period.

Much more important as a factor contributing to inflation were the huge Federal deficits of World War II. The debt incurred during that period was largely monetized as it became lodged in the banking system, and contributed importantly to the price inflation in the immediate postwar years (see the answer to question 3, above). A second factor contributing importantly to price inflation throughout the postwar period has not been related to the deficit, per se, but to the sheer size, or weight, of Federal expenditures for final goods and services relative to the aggregate value of such goods and services produced by the economy (gross national product). Total Government expenditures (Federal, State, and local) in the year 1957 alone amounted to over $86 billion, and accounted for roughly 20 percent of GNP.

It is a mistake to assume that a balanced Federal budget is neutral with respect to prices and that deficits and surpluses have, respectively, inflationary and deflationary effects. As has been indicated, inflation occurs when the aggregate effective demand for goods and services exceeds the Nation's capacity to produce. When the economy is already fully employed in producing goods and services for the private sector of the economy, a high level of Government expenditures is inflationary. This was the expedience of 1956–57. Excessive Government expenditures have contributed to inflation in too many of the postwar years.

15. The possibility of achieving full employment and stable prices: As indicated in the answer to question 11 (b) this question, in the final analysis, can be answered only by trial and error. We have had no experience with an economic system in which a concerted effort has been made to achieve full employment with stable prices. The experience of the 1920's, when consumer prices were relatively stable at full employment levels, does suggest that these two goals are not incompatible under appropriate economic conditions. At the very least, properly coordinated fiscal and monetary policy could go a long way to achieve these objectives. The objectives are important; a well thought out program to realize them should be given a fair trial.

16. Escalator clauses in wage contracts as a cause of inflation: Escalator clauses in wage contracts have not been, up to this time, an important cause of inflation, although in certain key industries they have undoubtedly intensified the wage-price spiral, once the consumer price index has begun to rise. Under escalator clauses, wages are

geared to prices in the first instance, not prices to wages. The basic causes of price inflation are overfull employment of resources and the labor force, complicated by monopolistic practices in trade unionism, and other factors mentioned in questions 4 or 11.

Although escalator clauses in wage contracts intensify the upward push of wages on costs and prices, after inflation has gotten underway, the practical importance of such causes as a factor contributing to inflation in the postwar period has probably been exaggerated. The National Industrial Conference Board estimates that at the end of 1957, 4 million workers were covered by escalator clauses in union contracts. In an economy with a civilian labor force of 68 million, this represents a coverage of less than 6 percent.

17. Causes of the present recession and techniques for combating it: Superficially, the current business recession was touched off by the sharp cutback in Federal defense spending after August 1957, and the efforts of manufacturers and others to reduce inventories to a lower level of new orders and sales. The basic factor, however, was the termination of the great postwar boom in capital spending, which had been stimulated by the pent-up demand of the postwar period, by technological wartime innovations and developments, and by the upward movement in plant and equipment costs. We now know that these capital expenditures were excessive, judged by what can reasonably be expected as to normal growth in consumer demand. Not only has excess capacity appeared in many industries as the capacity to produce has grown to exceed final demand, but the inducement to invest has also been lowered by declining profit margins as wages and other costs of operation rose faster than prices in many fields, particularly in industries where prices are fixed by law, custom or long-term contract. As unemployment rose with defense cutbacks and inventory liquidation, consumer expenditures stabilized and then turned downward, thus further complicating the problem of excess capacity which had already appeared in many fields.

If our diagnosis of the causes of the current business recession is correct, the recession is more deep seated than the earlier postwar adjustments of 1949 and 1953–54. The basic problem now, as in all recessions, is to raise the level of aggregate effective demand so that it approaches more nearly the Nation's capacity to produce, but at the same time, to avoid proceeding so rapidly that aggregate demand once again exceeds capacity, thus touching off another inflationary spiral.

There are a number of devices available to combat the recession, including the following as perhaps the most important:

(1) Active monetary ease on the part of the Federal Reserve System, supplemented by appropriate debt management by the Treasury to avoid funding short debt into long.

(2) Immediate acceleration of Federal disbursements under existing contracts to offset the decline in private demand.

(3) An across-the-board reduction of Federal income taxes (corporate and personal) and a reduction in burdensome excise taxes and other special levies such as the emergency wartime tax of 10 percent on transportation of passengers.

(4) As a last resort, a stepped up program of Federal, State, and local public works, provided items (1) to (3) are insufficient to restore aggregate effective demand to appropriate levels.

The first steps should be taken in the monetary sector and in speeding up disbursements under existing contracts and appropriations, since such steps can be taken promptly and with a minimum of disturbance to the Federal budget. In view of the character of the present recession, such steps may prove insufficient to restore business to full employment levels, if we are right in our judgment that we are now in a long-term downward trend in plant and equipment spending. But whether this proves to be the case or not, tax levels and the tax structure are very burdensome and seriously impair economic efficiency, and a reduction would do much to strengthen lagging consumer spending and capital demand. An across-the-board reduction of, say, 10 percent in personal income tax would stimulate spending for consumer durables, transportation, et cetera, which have been hard hit by the recession. Such a reduction would also exert the minimum of pressure on such basic items in the consumer budget as food and personal services, and would thus reduce the risks of further inflation. Corporate income and excise taxes are also excessive, and revisions are long overdue.

Public works should be resorted to, only if it becomes clear that all other devices have failed. As a general rule, it is better to permit the consumer to enjoy the fruits of his labor rather than to siphon off a large share of what he produces for Government projects of a marginal nature. The postwar experience indicates that public works usually operate only after a long delay, and begin to take hold well after the recession is past, thus contributing to price inflation. A reduction in taxes would stimulate demand at the time it was needed, and would reduce costs and selling prices, thus removing one cause of inflation.

AMERICAN GAS & ELECTRIC CO.,
New York, N. Y., March 25, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Thank you for affording me an opportunity to express to you and your committee my thoughts on some problems that have been troubling members of the committee as well as others, including myself, for some time. While I do not believe that I can usefully address myself to each of your individual questions, I do want to express to you a few thoughts on those matters in your letter which appear to me to be particularly significant.

At the time I write this letter the economy is faltering in a recession which shows signs of reaching a severity well beyond that reached in the previous two post-World War II recessions, in 1948–49 and in 1954. Despite the frequently repeated assurances emanating from various quarters that we are experiencing something minor and shortlived, the key economic indicators continue to point down and the latest report on unemployment gives grave cause for concern. Nevertheless, I believe that, with appropriate governmental policies, including, particularly, fiscal and monetary policies, this current recession can in fact be contained and made relatively short-lived, after which the economy would once again resume its growth. But, if this is to result, vigorous action must be taken promptly. I do not exclude an immediate tax cut from this action. Otherwise the economy may fall to much lower levels from which recovery will take much longer, and then only at far greater cost. From your letter it appears that you and your committee are more concerned with the long-term problem of how to assure the maintenance of a proper rate of growth to provide the American people with the ever-rising standards of living which their resources and ingenuity entitle them to expect. But even in dealing with this long-run problem the short-term recession and boom phenomena must be kept in mind.

I might first point out that there has devolved upon the Federal Reserve Board the major responsibility to provide the monetary means for the maintenance of an adequate rate of long-term growth while at the same time maintaining stability; i. e., full employment and a stable price level. While the experience in the immediate postwar period emphasized, if any emphasis were needed, the desirability of sustaining the independence of the Federal Reserve Board from partisan political considerations, at the same time it indicates that the problems of economic stability and long-term growth are much too important to be subject to the exclusive determination of a relatively small group representing, essentially, the banking community and their point of view and having no accountability to the public for decisions having the gravest implication in terms of the public interest.

For example, the decision as to what is the appropriate rate of growth is much too important in terms of the National welfare to

remain the exclusive domain of a small group of insulated men, however able, patriotic, and well-intentioned. Hence, some way should be found to bring to bear, both formally and effectively, the judgment of a larger group more responsive to the overall needs of the country. Certainly in the last few years the Federal Reserve Board in its efforts to be conservative has, in fact, been overcautious in its monetary policies and its attitudes toward economic growth. There is considerable doubt that they have made credit available in adequate quantity to sustain the economic system at a consistently high level of activity and to provide the needed monetary mechanism for continuing expansion.

It has been argued by some that this country may have to choose between slow, creeping inflation and unemployment. While this is a question that needs much more study before the final answer can be given, it does not appear to me that in the case of a free people intelligently guiding its own destiny this necessarily must be so. And even more there is ample reason to question whether monetary policy can offer anything but a small portion of the solution to this difficult problem. But granting that credit control does have an effect on it, the question clearly is one of such great and fundamental importance that it goes far beyond the area in which the Federal Reserve Board should be free to roam at will. In effect, then, I am suggesting that consideration be given to some methods whereby broader points of view can be brought to bear in the decision-making process in this extremely important area of responsibility. Also, some procedure should be found to coordinate the fiscal and other general economic policies of the many governmental and semigovernmental bodies concerned with these problems so that, given a policy decision, the various agencies follow that policy rather than contradictory courses of action.

Of course, one of the questions about which we know all too little refers to the timing and effectiveness of monetary policy. Much too little is known about the length of time required for changes in monetary policy to have their full impact on the economy in various circumstances. But we do know that there is a lag, both in taking hold and, so to speak, in letting go. The lag between the imposition of monetary policy and the result it sets out to accomplish may be such that, unless the greatest skill and care is exercised, insensitive monetary policy can be carried to excess in any particular direction. For example, after the imposition of monetary restrictions the various key indicators may, and generally do, continue their upward movement for some period of time. This delay, or inertia factor, may well lead the monetary authorities to impose additional restrictions which push the economy too far in the opposite direction from that in which it had been moving.

Such a development was clearly illustrated last August when the Federal Reserve Board raised the rediscount rate at about the same time that, we now know, economic activity had begun significantly to taper off in response to earlier restrictions. Although the present recession undoubtedly cannot be attributed entirely to the Federal Reserve Board's tight money policy, the additional restrictions imposed late in 1957 now appear to have been contrary to what was called for. And this, I believe, could have been anticipated in 1957. Greater attention, therefore, should be given to the development of more objective criteria for policy determination.

There is also considerable doubt concerning the effectiveness of monetary policy alone in stemming strong movements in the economy, either up or down, once momentum develops. It does appear, however, that it is less effective in stimulating an upturn than it is in curbing a boom. Because easy credit may be only one, and perhaps not the most important, of a series of inflationary influences, it may well be that to be effective in restraining such excesses, monetary policy must become so stringent as to greatly damage wide and important sectors of the economy. The growth and strength of the economy and the mitigation of inflationary pressures must, in the final analysis, depend upon growth in output at a sufficient rate to supply the ever-increasing per capita needs of the civilian economy while, at the same time, providing the goods and services necessary for the defense of the country.

This growth in output necessary to restrain inflation can result only from an increase in productivity and this, in turn, can be brought about only by the increased use of machines and inanimate energy. Yet it is the investment in productive plant and equipment which is precisely the area most severely inhibited by stringent monetary policy. It therefore seems desirable to give consideration to avenues of approach which may make possible the moderation of the effect of monetary policy on these productive and inflation-restraining investment areas.

I would also like to raise a point about the influence on monetary policy by the commercial banking community which cannot escape a direct interest in maintaining high rates of interest. In raising this point I do not intend in any way to impugn the high character or sincere motives of the banking community. I simply indicate an area in which their job has been made more difficult by creating a possible conflict of interest between private and public good. While it is obviously an extremely difficult question with which to deal, consideration should perhaps be given to the possibility of reducing the influence of commercial bankers in the decisional processes involved in the formulation of monetary policy. Perhaps one method of doing this would be to provide larger and more effective nonbanking representation in this connection.

Complementary to monetary policy, so far as it relates to encouraging capital growth, is the problem to be found in the tax structure, and particularly our income tax structure. In recent years the nature of our tax system has tended increasingly to discourage capital formation, risk-taking investment, and the kind of enterprise which in a free economy has served to make this country the greatest industrial nation on earth. Certainly a restructuring of the tax system is called for to eliminate those aspects which at present tend to discourage both individual and corporate efforts in expansion and innovation. Machinery and equipment in ever-increasing amounts, as well as managerial and entrepreneurial skill and talent of the highest quality, are necessary to provide the increasing productivity from which we can get ever-rising standards of living. These must be encouraged rather than throttled.

If in the process of growth we are to avoid inflationary pressures, the rewards of labor must not increase faster than increased productivity makes possible. Otherwise we will not be increasing income

but will merely be redistributing it. I do not mean by this that labor should be deprived of its fair share of the national income, but I do point out, however, that over a period of many years, and particularly over the last decade, labor unions have continued to strengthen their monopolistic position and to use their legislatively acquired and legally protected monopolistic powers to obtain for themselves an increasing share of the national income. This has been done at the expense of the vast majority of people on salaries, pensions, or other fixed incomes. The real incomes of these groups have been reduced and their accumulated assets drastically cut in real value. Monopoly power has in recent years made it possible for organized labor to insist upon wage increases far in excess of the increases in productivity. These increases have clearly contributed to inflationary price movements—in my judgment they have been the largest single contribution. I do not believe that labor should be denied its rights to organize and to bargain collectively, but I do believe that unions should not be permitted to exceed the limits of fair market behavior in the light of the general public interest. A great deal of thought and effort needs to be given to this entire question and, while I recognize that a satisfactory solution will not be easy to find, this should not deter our attempt to make some progress on the job.

I do hope that the foregoing will contribute to the finding of answers to the general problems indicated by your specific questions. If I can be of any further assistance, please do not hesitate to call on me.

Sincerely yours,

PHILIP SPORN, *President.*

THE PENNSYLVANIA RAILROAD CO.,
April 15, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Enclosed are answers to the questions which you sent to me in connection with the Senate Finance Committee's inquiry entitled "Investigation of the Financial Condition of the United States." One of the questions has been omitted as requiring a highly technical answer and several others have been grouped for ease of exposition.

In discussing the answers to these questions with my staff, we were naturally most interested in those questions which had a direct bearing on our own industry or which could be discussed in terms of railroad problems. Questions 6 (*b*), 7, 8, and 9 contain information relating directly to the railroad industry. Comments on taxes in question 17 also refer to matters of particular interest to railroading. The whole broad problem of inflation is of vital concern to us, however, and I am glad to submit answers on the more general questions.

I hope that the comments on the questions will be helpful to you and to the staff of the committee. I shall be most interested in following your deliberations and I would appreciate receiving copies of future publications.

Respectfully,

J. M. SYMES.

QUESTIONNAIRE ON THE FINANCIAL CONDITION OF THE UNITED STATES COMPLETED FOR THE COMMITTEE ON FINANCE, UNITED STATES SENATE, BY J. M. SYMES, APRIL 15, 1958

1. Give a definition in your own words of deflation and inflation.

Inflation is a persistent and substantial rise in the general level of prices, sufficiently severe and of such long duration that a dollar appears to lose some of its purchasing power for an indefinite period. Deflation is the opposite—a protracted decline in prices. Inflation is usually accompanied by expanding credit and rising money income, and deflation usually entails credit liquidation. However, a definition of inflation and deflation in terms of their causes begs the question to which the Senate Finance Committee has addressed itself. No fruitful line of inquiry into the reasons for price fluctuations should be ruled out in advance by pat explanations.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

The economy of the United States is influenced by many factors which are best described as social or political as well as by many which have their origin in the business of making a living. Thus, the tradi-

tional approach of control over money and credit, though vitally necessary, is not sufficient. There are probably many ways—not just one—in which inflation and deflation can be avoided or mitigated; and, conversely, it will probably require action on many fronts to build an effective program.

By its nature, the quest for economic stability requires that legislation give wide scope to administrative policy. Legislation cannot hope to deal with changing economic problems in detail. The objectives of economic policy and the criteria of its effectiveness can be made clear, however, and constant legislative review can encourage responsible action.

One proposal for a change in existing legislation which should be seriously considered is that of making price stability an objective equal in importance to "maximum employment," as defined in the Employment Act of 1946. This would change the tenor of that basic piece of legislation, making explicit the realization that no one standard, such as full employment, can be absolute, to be achieved at the expense of other critical aims. It would help to correct a depression-born bias in favor of inflationary policies and a tendency to bypass the tests of free markets—for labor as well as for goods.

Another area which demands attention is the budgeting and expenditure practices of the Federal Government. This probably involves many separate pieces of legislation, some of which were suggested by the Hoover Commission. In general, controls over the timing of expenditures should be more firm. Provision should be made wherever feasible for slowing down or accelerating particular spending programs in accordance with the needs and capabilities of the economy. Similarly, the programs of certain administrative agencies (for instance, the Federal Housing Administration) should be made responsive to changing levels of business activity and to the programs of the fiscal and monetary authorities.

Still another large group of laws which demand reexamination are those which govern business-labor relationships. Much of the present legislation was conceived and enacted in an era in which the balance of power was different than it is today. Without pausing to examine the reasons or to discuss the social implications of this changing balance of power, it is nevertheless appropriate to point out that existing legislation has resulted in the creation of an extremely powerful force for continued wage increases—increases often in excess of long-term productivity gains. This does not mean that the blame for wage inflation is all labor's. In fact, management must share the responsibility for existing wage structures. It does suggest, however, that the institutional machinery which brings about excessive and inflationary wage increases—and this may include, among other things, industry-wide bargaining, for instance, or monopoly power on the part of unions—bears correction. Here, too, the administrative agencies may need new general instructions more in tune with the times.

Perhaps more than new laws, the Nation needs a clear understanding of the problems of inflation and deflation and the will to act on the basis of what is already known and the tools already in hand. This inquiry of the Senate Finance Committee is one step in that direction, but more needs to be done. Both labor and management can find ways

to help mitigate both evils by their own actions. Long-range investment planning by management is one fruitful procedure; labor might well adopt an analogous approach instead of the policy of bargaining for what the traffic will bear at the moment.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

From 1942 until the time of the accord with the Treasury, Federal Reserve policy was dominated by considerations of Federal financing rather than by the requirements of economic stability. In fairness, it must be pointed out that the experience of World War I and of the depression years seem to indicate that protection of bond values made a major contribution to a healthy economy. However, subsequent events proved that under any but strict wartime controls, the support of Government bond prices did, indeed, make the Federal Reserve an engine of inflation. The period from 1942 to 1950, therefore, might well be divided again into at least two: That which extended until the end of World War II, during which successful war financing had to be insured at all costs; and another which began in 1946, when the Nation began to shake loose from price, wage, and production controls. Under the latter conditions the program of bond price support was inappropriate.

From 1951 to 1957 the Federal Reserve was free to act as it saw fit in influencing money and credit conditions. For a short time, during the Korean war perid, it had the right to establish specific selective controls over real estate and installment credit. Such controls, though more general and less restrictive than price, wage, and production controls, are probably appropriate only under war or near-war conditions. As soon as urgent defense requirements were met after the Korean truce, it became extremely difficult to define the objectives of selective controls, much less enforce them without using stringent and costly methods.

The record shows the years 1952 through 1955 to be a period of economic growth and relative price stability. The recession of 1954 was very serious for some segments of the economy, including the railroad industry, but, in general, the slump was well contained and undoubtedly Federal Reserve policy helped to keep it so. If the letup on credit restraint was too great in 1954–55 and gave rise to excessive demand in subsequent years, this was, by hindsight, an error of degree. By the same token, if the rather sharp restrictive action of 1957 was late, this was an error of judgment in which the Federal Reserve was joined by the majority.

One final observation may be made. The Federal Reserve alone cannot insure business stability. Yet the seriousness of the current recession and the strength of the boom which preceded it, points to the need for action other than that which sufficed earlier in the postwar period. The Federal Reserve should take advantage of the considerable flexibility which it has and should not be bound by the policies of earlier years. The financial community should not be subjected to frequent changes in the rules of the game; however, it is not the rules which must be stabilized, but the economy.

4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

The rise in the Consumer Price Index in 1956 and 1957 is the result of many factors. Some of these may be lumped together under the heading of "Business Boom," for this is exactly what the economy had been experiencing since 1955, particularly in the capital goods fields. During much of this period labor was tight and production facilities in many lines were strained. Combined with this was the persistent tendency for wage increases to exceed increases in productivity (especially under the conditions which prevailed in 1956 and early 1957) and, therefore, for unit costs of production to rise. It is difficult, in these circumstances, to pick 1 or 2 factors more important than the rest. Failure to place more severe restraints on credit soon enough and failure to restrain Federal Government spending, though negative factors, are probably as important as any others.

If the rise in prices from 1956 to 1958 were likely to be compensated for by falling prices in subsequent years, the decline in the value of the dollar for the period would be a transitory thing and, though troublesome, not excessive. But if the postwar pattern repeats itself, as is likely, the decline in prices will not be allowed to take place, thus making the loss in the purchasing power of the dollar permanent and injuring many individuals and industries. This is far more serious than a price rise during any limited period. And the factors most responsible for this are the whole gamut of full employment and labor policies, applied without regard for the structural damage to the economy caused by creeping inflation. Maximum employment does not require creeping inflation to support it. But inflation comes easily unless specific steps are taken to avoid it.

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The details of debt-management policies and their impact are highly technical. Suffice it to say here that the size of the public debt is so great that the refunding of old issues and the raising of new money from time to time cannot fail to have a profound effect on the economy. The Government is, of course, in competition with private interests for investment funds. The Government can, therefore, do much harm by inappropriate timing of its financial operations and by the issuance of inappropriate types of securities. It is difficult to see how debt-management policies in themselves could do any positive good for the national credit structure; but appropriate policies can probably contribute to orderly money markets and to a desired increase or decrease in liquidity generally, as business conditions might require.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends

since World War II—during the most recent 2 or 3 years—and especially during 1957.

(*a*) All three of the objectives are important and all are interdependent. Attempts to achieve one without the others will fail. Stable prices establish continuity and confidence and preserve economic incentives. Without them, growth is distorted and may ultimately be frustrated. But stable prices cannot be achieved without regard to the need to maintain a high level of employment and production. Finally, serious recessions can be avoided only if conditions favorable to long-term economic growth are maintained.

None of these objectives, however, can be completely fulfilled at all times if we wish to have the best possible combination most of the time. This paradox is readily explained. An economic system characterized by individual initiative and free markets yields the biggest dividends in balanced growth and good living. But such a system is flexible and must proceed by testing new products and ideas in the market place. Such a system requires some leeway—there are profits and losses, obsolete products as well as new ones, and so on. While we should continue to try to minimize periods of both unemployment and excessive demand, we should recognize that there will always be shortcomings to overcome. We should not fall into the trap of trying to meet completely any one objective, rigidly interpreted.

(*b*) From the end of World War II until the present, making allowances for the special conditions brought about by the Korean war, the United States has enjoyed reasonable stability of production, demand, and employment at a high level of economic activity. The Nation has also enjoyed fairly steady growth in real income. The events of the last few months, however, raise important questions. Has this growth been well balanced? Have production and demand conditions been sound in the sense that high-level stability can now be maintained indefinitely?

The answers to these questions may hinge on the effects of another important trend that has been strong since the war—the trend toward almost continuous inflation. Immediately after World War II, the reasons for inflation were clear—too much war-deficit money, too little goods. The reasons for the resumption of inflationary trends within the last 2 years are less easy to describe and more disturbing because, under existing conditions, there is no end to the process in sight. These reasons were alluded to in questions 2 and 4 above.

The impact of inflation has been uneven, and this is precisely why it can distort economic growth and give rise to instability. The railroad industry furnishes an example of the destructive power of inflation and its ability to do permanent injury to the economy. Control over rates in that industry and ratemaking criteria which fail to take the rising cost of capital equipment and construction into account have placed the railroads in a financial squeeze. The inevitable lag between rising operating costs and rate adjustments and failure to provide an adequate rate of return for the industry have cut railroad earning power and have made it impossible for the industry to invest at a rate which will enable it to keep pace with the desired rate of economic growth. This, in turn, acts as a drag on the entire economy and allows investment funds to go into other channels which may, in the long run, be less productive. The effect of inflation is only one

of a number of important problems facing the railroads, but it is one which is also significant for other industries. The proposal for an investment reserve made before the Smathers committee (Surface Transportation Subcommittee of the Senate Committee on Interstate and Foreign Commerce), if accepted, would help to alleviate the railroads' position, but the basic problems of inflation remain.

7, 8, 9. Give your opinion of the effect on our economy of current Federal, State, and local government spending. Give your opinion of the effect on our economy of current Federal, State, and local taxation. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

At current levels, the effect of Government spending on the economy is very great indeed. When it spends, Government competes with the private sector of the economy for goods and services. This has several effects. First, it places resources where the Government directs, rather than where free markets direct. Second, when goods and labor are relatively scarce, it creates the danger of inflation. If there is unemployment, additional Government spending may stimulate the economy—provided the expenditures are of a type that do not injure private business or public confidence.

The high level of Government spending is often said to provide a cushion or prop under the economy. In a sense this is true—if we assume, as now seems likely, that we are committed to high defense outlays for an indefinitely long period. Yet, this is a cushion which we hope can be reduced. Government expenditures should not be looked on as a device to ensure maximum employment, but, rather, as a means of accomplishing those things which only Government can do. Of course, proper timing of necessary government outlays can and should contribute to economic stability.

To a large extent, the effects of Government spending depend on the means by which it is financed. Paying for Government service out of taxes is, undoubtedly, the best policy, though here, too, proper timing can contribute to stability by generating a surplus when business is booming and private debt is growing and by allowing a moderate deficit, if necessary, when private incomes are depressed. There is no prospect of doing more than chipping away at the Federal debt, but it can be kept from increasing. Meanwhile, as indicated in question No. 5, debt management can also play a constructive role. But in concentrating on the cyclical effects—the short-term effects—of taxation, the long-run impact of the tax structure in the economy is too often overlooked. Since taxes are so high, it makes a great difference to the health of the economy what is taxed and who is taxed. In general, the present tax structure is unfavorable to equity investment and to risk-taking generally, especially in new and small enterprises.

Present concepts of Government spending and taxation also have a tendency to distort economic development and to allow an inefficient use of resources. Nowhere is this more apparent than in transportation. Without an adequate system of user charges, large Government outlays on the waterways, airways, and highways appear to be costless to those who use them. The railroads, who provide their own

right-of-way and facilities, are placed at a competitive disadvantage and suffer a loss of traffic and ability to attract capital to means of transportation, whose true cost is higher. The public pays the bill and gets a less efficient transportation system.

A lack of balance between Federal and State and local tax sources also creates difficulties. Heavy burdens on business in some areas make it impossible for the region to realize its economic potential. And here, again, the railroad industry, a large property owner, frequently bears a disproportionate load. Much needed local tax reform depends to an important extent on the resolution of national tax policy questions. This problem is becoming more urgent as State and local needs expand.

The long-term problems referred to above are chiefly in the area of fiscal policy. Monetary policy—the policy connected with the supply of money and credit—can assist in their solution, though it is chiefly concerned with short-range changes in business conditions. The independence of monetary policy from direct control by the administration often appears incongruous in view of their close relationship; but this type of check and balance is probably worth preserving in an area in which temptations for abuse are strong.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Omitted.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy.

Within the last year, some prices—chiefly those comprising the consumers price index—have risen while production and employment have fallen off. The explanation is twofold. First, there has been a tendency for price adjustments to lag behind business events. The momentum of the price rise of 1956 and early 1957 has carried forward, especially in view of rising farm and food prices. Second, the policies and institutions discussed in questions No. 2, and No. 4, have given prices a strong underpinning. Rigid—in fact rising—wage rates have kept unit costs high. (Escalation agreements have contributed to this.) Competition is slow to take effect when the expectation is for Government action to continue the upward price movement.

11 (*b*) and 15. Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals? Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?

Certainly a gradual inflationary trend is not desirable. It robs those who depend on fixed incomes, destroys business continuity, distorts economic decisions, and is likely, ultimately, to turn into inflation of the galloping variety. High levels of employment can be maintained without continuous inflation. Moderate business fluctuations, however, should be expected. Insistence on completely full employment at all times would probably result in chronic inflation.

12. To what extent and in what way do you believe that the growth

of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Private indebtedness has grown rapidly in recent years. In part this growth has seemed very sharp because of the liquid condition of business and consumers at the end of World War II. At this time corporate indebtedness is not a threat to stability, but its continued increase at recent rates would be questionable. The present tax structure encourages debt financing and should be reexamined on this score. Personal indebtedness has grown even more rapidly. While it does not appear that it is at the danger point, there is no doubt that consumer durables purchases may now be subject to more severe fluctuations by reason of the need to pay off indebtedness every once in a while, especially when incomes stop rising. There is a limit in sight, too, to the continued liberalization of mortgage credit terms.

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Deficit spending, in the sense of the Federal Government's spending more cash than it received, has been a minor factor. In most years, including the last 2, there have been cash surpluses. The huge increase in the money supply, which contributed to the postwar inflation, was created by deficit financing during the war. The Federal Government might have stemmed the tide of inflation to a greater extent by running bigger surpluses and smaller deficits.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Escalator provisions, though they serve to solve problems in particular instances, tend to accelerate an inflation or deflation once it is underway. Under present conditions, events would probably not be much different in the absence of escalator provisions, but it might be possible to gain a little more flexibility which would help to create more stable conditions. At the present time, for instance, a continued rise in the consumers price index is forcing wages up at a time when unemployment is increasing. The absence of escalator agreements would not cut off wage-increase demands, but it would allow for more realistic bargaining. The main forces making for instability are to be found elsewhere, however.

13 and 17. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

There is probably no single measuring point at which large tax cuts or increases in public works are certainly indicated. When any particular point is reached, the trend of business is also a most important factor. Five million unemployed may be very serious or not, depending on surrounding circumstances.

There is no doubt now that the current recession is more serious than those of 1948–49 and 1953–54. This downturn comes at a time when the backlog of consumer needs for durable goods is completely dissipated. Furthermore, this downturn was initiated not only by inventory liquidation, but also by a decline in expenditures for capital

goods which came after a period of very large investment. The heavy goods industries are seriously affected.

Under these conditions, Government action can be helpful in moderating the recession and in bringing an upturn in business closer. The form of this action, however, is very important. Indiscriminate tax cuts giving rise to large deficits, and large increases in public works commitments giving promise of deficits to come, might after a short time, overcorrect the slump and create the ingredience of a new inflationary push. Careful action on taxes, however, might be salutary at this time. The immediate problem is not inflation, and it might be possible, therefore, to afford some stimulation to the economy while at the same time making a start on tax reforms which are long overdue. The repeal of taxes on transportation has been recommended for some time and it should be carried out now. These taxes are obsolete and discriminatory. Other excise taxes might well be reduced or repealed as an aid in bringing prices down and in relieving certain industries of competitive disadvantages. Consideration should be given to a reduction in the corporate income tax and to liberalization of depreciation on regulations, to bring them into line with investment needs. Finally, if the situation warrants, a start might be made on the reduction of individual income taxes along the lines (but not necessarily to the same extent) recommended by the Sadlak-Herlong plan. The extent to which the plan can be followed at this time is limited by the immediate need to stimulate consumption quickly.

Such action must be taken with care and the full realization that entirely different policies may be called for before many months go by. If action is taken which will improve the tax structure rather than merely reducing the total tax take, we will have made an investment in the future which is not without risk but which has the maximum chance of success.

MICHIGAN CONSOLIDATED GAS CO.,
Detroit, April 10, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This is in reply to your letter of February 17, relating to the Senate Finance Committee's investigation of the financial condition of the United States. The questions you present for comment are indeed thought-provoking and most pertinent to the basic problems of assuring continued economic growth and preserving the purchasing power of the dollar—objectives with which I am thoroughly in accord.

During my many years of experience in the public utility business, I have had occasion to observe the impact of price increases, fluctuations in consumer incomes and expenditures, taxation, and the relative availability of credit on our company and the communities it serves. There are, on the other hand, certain matters covered in your questions of which I have no first-hand knowledge or experience; such matters I shall leave for discussion to those who are more intimately acquainted than I with their practical and theoretical aspects.

Before turning to the consideration of specific aspects of governmental and private finances as they relate to this area and my particular business, I would like to mention briefly those social and economic goals toward which, in my opinion, our political and economic efforts should be directed. Too often, I fear, these goals are lost sight of in the press of day-to-day events, or are subordinated to the interest of one or another group.

First among these goals I would place the balanced development of our country's natural and industrial resources, to the end that all may enjoy a continued rise in their standard of living. Secondly, I would urge that this development be sought within the framework of competitive free enterprise, involving the minimum amount of governmental regulation, supervision, and intervention necessary to its realization. Of course, in my field—the public utility business—governmental regulation is necessary and accepted. Third, I would emphasize the importance of maintaining a stable purchasing power of the dollar as essential to economic development. Fourth, I would stress the heavy burden of responsiblity that rests upon each segment of the economy and each economic group for relating its claims upon the national output of goods and services to its contribution to the production of these goods and the providing of these services. Fifth, and finally, I would underline the vital necessity for political and economic statesmanship in defining our economic goals and inspiring us toward their accomplishment.

The public utility business, as you well know, is not a free agent in our competitive, free enterprise economy. While subject to all the pressures exerted by rising labor and material costs and increases in

taxation, the public utility must sell its products at prices which are prescribed by the various State and Federal regulating commissions and which in turn are determined on the basis of fairly rigid and inflexible formulas. Prior to World War II and its inflationary heritage, the price of public utility services to the consuming public was trending downward; since World War II utilities have been forced to raise their rates, but the increases granted them by the regulatory commissions have not for the most part kept pace with the rising costs of providing such services, particularly if consideration is given to the cost of replacing facilities. Michigan Consolidated Gas Co. has for years been replacing large amounts of old property at a cost many times in excess of the original cost, although only the small original cost is permitted to be recovered in our rates. Moreover, the relocation of facilities has of late become a serious burden. For example, the company has been spending large sum in recent years to replace facilities necessitated by the clearance of right-of-way for arterial highways and other municipal improvements. This replacement, which adds little or nothing to the overall capacity of our distribution system, imposes a heavy burden on the company's finances and earnings. We believe that some recognition should be given in our tax and rate regulation to this high cost of replacing facilities which represents an actual but in many ways hidden attrition of capital.

While we recognize that adequate national defense and the multitudinous service expected of Government in this day and age require the imposition of heavy taxes, we do feel that every effort should be made to achieve maximum economy in Government. As recently as 1948 our total taxpayments amounted to 8 percent of total revenues; in 1957, by way of contrast, taxpayments exceeded 14 percent of total revenues.

Citing the above illustration in answer to your question about the effect on our economy of current Federal, State, and local taxation, I would say that not only are taxes unduly burdensome but also—and much more important to our future economic development—they diminish the incentives to further expansion and reduce the volume of funds available for this purpose. My company's tax bill for 1957 exceeded $18 million, which was twice the amount distributed to stockholders in dividends, and roughly 78 percent of that year's capital expenditures. Net income after taxes amounted to 8 percent of 1957 gross revenues. Return on invested capital amounted to 5½ percent.

As regards labor costs and wage rates, there are some reflections I have which cast doubt on the compatibility of escalator provisions in wage contracts with the achievement of economic stability. One important aspect of the public utility business is the servicing of customers equipment and appliances; another, the reading of meters and the inspection and repair of distribution lines and equipment. So far as these activities are concerned, there has been little or no increase in productivity in recent years, despite the fact that our average wage costs have risen from $1.50 per hour in 1948 to $2.50 per hour in 1957. One man reads just about the same number of meters per day at the present time as he did 10 years ago; the servicing of more numerous and complex appliances requires considerably more man-hours now that it used to, and much of this servicing is provided without specific

charge to the customer. Since many of the jobs for which we hire people cannot be mechanized, and since the productivity of such labor is subject to only nominal improvement, any increase in basic wage rates can only be recovered by raising the price of our product. At the same time we must compete for labor with companies that are able to recapture some part of increased labor cost through increased worker productivity. When the wage rates of labor in those industries are advanced automatically with increases in the consumer price (cost of living) index, it puts pressure on other industries and services to increase their wage rates, irrespective of their ability to pay or to recapture such increased costs. The program feeds on itself and the effect is depressed earnings or serious losses for many businesses, with resultant unemployment, and more inflation and even higher prices to the public.

Turning briefly to the subject of the present recession, I would say that what we are experiencing is a reaction to a period of long-sustained and abnormally large consumer and business investment. Studies show that inventories are still high, and that consumer indebtedness is at an alltime peak level—both absolute and relative to disposable income. Since the end of the war, moreover, industry has been engaged in a massive capital expenditure program involving upward of $290 billion which has resulted in a substantial addition to productive capacity. It was inevitable too that such expenditures would taper off at some point, since additions to plant and equipment are seldom correlated precisely with growth in demand for the products of industry.

Although restrictive credit policy has been blamed by some people for bringing about the current recession—and I do believe that we went from soft to very hard money too precipitously—it seems to me that temporary fulfillment of consumer purchasing capacity and the emergence of temporarily excess productive capacity are more likely causes. In the absence of a restrictive credit policy which forced the postponement of some marginal business capital expenditures and the deferral of some consumer purchases, the business boom might have reached higher levels and the resulting readjustment might well have been of more serious proportions.

This is not to minimize or treat casually the current recession which has already brought hardship, uncertainty, and suffering to many pleople. It only emphasizes the necessity for prompt and enlightened action to meet the problem. To my mind, the thing we now need is the restoration of confidence in our business and economic system. It cannot come through the revival of illusory schemes which, even within the memory of many of us, have proved themselves failures. Rather, confidence must come through the adoption of sound financial and fiscal policies so that inflation can be controlled and the average citizen protected.

May I add that your willingness as expressed in the press to continue in public life, despite the many personal sacrifices required, is most heartening to us all.

Hoping that the foregoing comments, which touch directly upon certain of the questions that you raised, may prove helpful to you and your committee, I remain

Very truly yours,

HENRY TUTTLE.

SUNRAY MID-CONTINENT OIL CO.,
Tulsa, Okla., March 31, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance of the Senate,
Washington, D. C.

DEAR SENATOR: I have your letter of February 17 and have given it much thought and study. I am very pleased in one way, but somewhat at a loss in another way, to try to offer suggestions about the questions on economic matters confronting the Senate.

However, I want to give you the information which has been assembled by our economics department, assisted by some other local people, banks, and so forth. It might be clearer and more understandable to give you a copy of their report to me, with letters written by others in the company also, and I am enclosing them. The report will, I am sure, contain information which you already have, but perhaps it may be prepared in a different manner, and with a different approach.

The problems before our leaders in Government are very great, and I am sure that you and others in public office are deeply concerned about them. The only comments that I feel capable of making are of a practical nature, coming from actual experience over a period of 40 to 50 years.

It seems to me that the greatest problem now facing the people of this country under our free-enterprise system is the high cost of high living, which has been brought about in the past 25 to 30 years. It is true, and we all realize, that our country has made great progress in that time, and our standard of living is much improved, and having become accustomed to such conditions, then it is very hard for people to console themselves during depressed times.

In our own business, we have found that one of the troubles we face is getting into a category of prosperity, and then there is a retrenching period. No one likes to give up the habit of good living.

At the moment, throughout the country we have a large number of people unemployed. I know there have been legislative efforts made to help carry this burden, but when many people are without work naturally the buying power recedes, and as a result general business is affected. It would be a fine thing if you in Washington could act more quickly to create jobs through public works, such as highways, and other substantial things that will be of a permanent nature, thus putting many people to work promptly.

For the younger generation, I think the greatest problem is the matter of taxes. It is quite discouraging for young folks today to try to accumulate anything when the tax burden is so great.

There is no need for me to say anything about the hows and whys, or the methods of doing these things. You know much more about that and have a lot more information, but I feel that immediate action is necessary and that time is of the essence of the present situation.

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I have no comments about foreign conditions. You in Washington have all the facts. We laymen do not, and therefore we are not in position to offer any constructive ideas. We continually tell our own people in our country that in order for our business to prosper and have a profit we must be productive and create more than we consume. No business can be profitable on any other basis, and neither can our country.

I have been a great admirer of yours, and I am delighted that you have decided to stay in the Senate.

I hope that you may get something out of the various papers which I am enclosing that may be worth while.

Wishing the very best for you and for our country, I am

Sincerely,

C. H. WRIGHT.

SUNRAY MID-CONTINENT OIL CO.,
Tulsa, Okla., March 27, 1958.

To: C. H. Wright.
Subject: Letter of Senator Harry F. Byrd dated February 17, 1958.

You submitted to me a letter dated February 17, 1958, from Senator Harry F. Byrd, chairman of the Committee on Finance of the United States Senate, in which he requested your opinion concerning certain economic questions confronting the United States Senate. He has circulated these same questions to a substantial number of leading corporate executives and economic experts.

At your direction I wrote to Senator Byrd, telling him that we would submit answers to his questions before April 1 as he requested.

These questions have been submitted to Mr. Robert O. Law, head of our economics department. Mr. Law has made a study of these questions and has prepared a written discussion of them, which is attached with his letter of transmittal of March 21, 1958. You will observe that Mr. Law has prepared his discussion by classifying in each section the questions bearing upon the general subject of the section, as suggested by Senator Byrd.

In preparing this discussion, Mr. Law has conferred with Mr. Elmo Thompson, with Mr. Paul Henry, and with me. I have read the discussion carefully and I agree with Mr. Law's conclusions.

The discussion prepared by Mr. Law might be classified as textbook economics, but he has added some particular observations which bear upon the problems of the oil and gas industry and also has presented the discussion from an employer's viewpoint. He has summarized his conclusions in his letter of transmittal to you of March 21, in which he has said:

"The position taken in this report is that, while the immediate problem is one of an economic recession, the long-term problem remains one of inflation. The most effective way to combat the recession is to take steps to reverse the decline in the rate of business investment. The problem of long-term inflation should be met by reducing the Federal debt, by making sure that tax revenues do not increase in the future as rapidly as does the value of the goods and services produced in this country, and by preventing monopolistic labor practices which force wages to rise at a rate not justified by increases in labor productivity. The Government can make its most effective contribution to-

ward ending the present recession by adopting sound long-term anti-inflation policies which will generate confidence in the stability of the dollar. Government economic policy should not be aimed at establishing a controlled economy but should seek to further the growth of the free-enterprise system."

M. D. KIRK.

D–X SUNRAY OIL CO.,
March 21, 1958.

To: C. H. Wright.

Subject: Senator Byrd's request for a statement concerning vital matters affecting our economy.

Senator Byrd's letter was accompanied by a list of 17 questions. Some of these questions duplicate each other. Thus question 11 and question 15 ask the same thing. Further, it is difficult to develop a coherent and well-supported statement of position on these vital matters by merely answering each question as it appears. I have, therefore, taken the liberty of adopting the suggestion made by Senator Byrd in the second paragraph of his letter wherein he states, "In preparing your reply it is suggested that you use the attached list of questions merely as a guide."

A study of Senator Byrd's list of questions shows that the ground they cover can be divided into four areas. I have, therefore, divided my report to you into four sections which cover, to the best of my understanding, all of the points raised by the Senator.

The four sections of this report, and the specific questions which are covered in whole or in part in each section, are:

Section 1: Discussion of definitions of inflation and deflation and the various types of inflation.

Covers questions 1, 4, 11, 12, 15, 16, and 17.

Section 2: The effect of Government fiscal and monetary policy upon economic stability.

Covers questions 3, 5, 7, 8, 9, 10, 14 and 17.

Section 3: Appropriate goals of Government economic policy.

Covers questions 6 and 15.

Section 4: Suggested policies for the achievement of these goals.

Covers questions 2, 10, 11, 13, 15, and 17.

The position taken in this report is that, while the immediate problem is one of an economic recession, the long-term problem remains one of inflation. The most effective way to combat the recession is to take steps to reverse the decline in the rate of business investment. The problem of long-term inflation should be met by reducing the Federal debt, by making sure that tax revenues do not increase in the future as rapidly as does the value of the goods and services produced in this country, and by preventing monopolistic labor practices which force wages to rise at a rate not justified by increases in labor productivity. The Government can make its most effective contribution toward ending the present recession by adopting sound long-term anti-inflation policies which will generate confidence in the stability of the dollar. Government economic policy should not be aimed at establishing a controlled economy but should seek to further the growth of the free-enterprise system.

You can appreciate, I am sure, the difficulty I faced in attempting to put together an adequate statement of your position, or that of the Sunray Mid-Continent Oil Co., relative to these important matters. I have consoled myself by recognizing that my report to you is merely a preliminary statement and that you will undoubtedly want to recast it to more completely reflect your views before sending it to Senator Byrd.

ECONOMICS DEPARTMENT.

SECTION 1. DISCUSSION OF DEFINITIONS OF INFLATION AND DEFLATION AND THE VARIOUS TYPES OF INFLATION

A. DEFINITIONS OF INFLATION AND DEFLATION

Defining inflation and deflation in terms accurate enough to reflect the important events which occur is extremely difficult. The task is made more difficult by the fact that deflation is not the exact opposite of inflation. However, it is not possible to suggest measures which the Federal Government should take in the areas of fiscal policy, management of the monetary system, and elsewhere to combat inflation or deflation without first arriving at an adequate definition of these two words. An example of the difficulty caused by using an imprecise definition of inflation is to be found among those who see a paradox in the fact that at times inflation and unemployment exist side by side in our economy.

Perhaps the most useful definition of inflation is to call it a decrease in the purchasing power of the dollar. This seems to be more useful than it is to call inflation an increase in the general level of prices, which is a more popular definition. It is possible to have a decrease in the purchasing power of the dollar even when prices do not change. This happens when a product is downgraded or diminished in some manner. The fact that a 5-cent candy bar contains less candy than it did some years ago is a case in point. Five cents buys less candy than formerly though the price of the candy bar has not changed.

It is also true that not all price increases are inflationary in nature. Price rises which reflect product improvements are not a form of inflation. The price of a gallon of gasoline has increased in the course of the last decade and this is true even if the gasoline tax is not included in the price. However, the quality of gasoline has been so improved that the useful power delivered in the cylinder has increased more rapidly than has the price. The gasoline dollar purchases more useful power today than it did 10 years ago.

The harm done by inflation lies in the manner in which it destroys the value of savings, insurance policies, fixed incomes, and so on. Such destruction cannot be truly measured by watching the movement of price levels. Defining inflation as a decrease in the purchasing power of the dollar places a finger on the heart of the matter.

It is not helpful to define deflation as an increase in the purchasing power of the dollar although this is what generally happens in the course of a deflation. The objectionable feature of a deflation is not an increase in the purchasing power of the dollar. Rather, it is the growing unemployment of labor and equipment and the consequent general economic stagnation which is to be feared.

There are a number of factors which lie at the root of a deflation. However, the mechanism which spreads the deflation virus throughout the economy is a relatively rapid decline in the general price level. Not all price decreases are deflationary in nature. Price drops which reflect the lower costs brought about by more efficient production techniques are actually a stimulant to economic activity. They result in an increased volume of sales and production and in a more complete utilization of men and machines.

When decreases in price become general and when they reflect a lowering of demand rather than of costs, the economy is in the grip of deflation. The most useful definition appears to be one which states that deflation is a decrease in the general level of prices which is greater than any possible decrease in cost levels.

B. THE VARIOUS TYPES OF INFLATION

The mechanism of inflation is as yet imperfectly understood. A more complete comprehension of the foundations of inflation is a prerequisite for effective Government action in this area. This represents a problem to which economists and others in business, Government, and academic circles could well devote more attention.

It used to be thought that the root of inflation was to be found in the money supply. Observers noted that when Government printing presses ran night and day creating additional currency, inflation generally resulted. The era of the greenback inflation in the United States in the 19th century was of this nature. The supply of money was increased more rapidly than was the supply of goods and services available for consumption. As a result, prices rose so rapidly that the greenbacks became virtually worthless. The answer to this problem, obviously, was to stop the Government printing presses and to withdraw most of this paper currency from circulation. Such a policy was adopted with the result that this particular inflation was halted.

The notion that all inflations are brought about by excess money supply is current in many quarters. The corollary is that all that is needed to stop an inflation is to manage the monetary system correctly. Unfortunately, inflation is a much more complex phenomenon than this position indicates and monetary management alone is not an adequate antiinflationary device.

There appear to be at least three basic types of inflations; purchasing-power inflations, cost inflations, and supply-failure inflations. During the course of any given inflationary period, it is probable that more than one of these types of inflation is present. Each of these types requires different corrective measures. Government antiinflationary policy in a specific inflationary period must be tailored to cope with the pattern of types of inflations present in the period in question.

Purchasing-power inflations are those brought about when purchasing power in the economy increases more rapidly than does the available supply of goods and services. The movement of excess purchasing power into the market bids up the prices of goods and services and the general price level rises.

There are two kinds of purchasing-power inflation, monetary inflation and credit inflation. In the case of monetary inflation, the supply of money (which includes demand deposits as well as currency) rises too rapidly. The remedy here is to contract the supply of money. Demand deposits can be contracted by having the Federal Reserve Board increase the reserves that member banks are required to maintain against demand deposits and by increasing taxes. Increased taxes, however, will reduce demand deposits only if the increased tax revenues are used to reduce the National debt held in the banking system. There will be no decrease in demand deposits if increased taxes are matched by increased Government spending or if increased taxes are used for redemption of Government bonds held by individuals, insurance companies, or pension funds.

The amount of currency in circulation can be contracted by having the Federal Reserve Board sell Government bonds in the open market and place the currency secured from the sale of these bonds into idle balances. Currency in circulation can also be contracted by requiring increased reserves against the issue of Federal Reserve notes.

Credit inflation occurs when an expansion of credit acts to cause purchasing power to increase more rapidly than does the available supply of goods and services. The type of credit involved can be credit granted to consumers to finance their purchases of consumption good, credit granted to producers to finance their purchases of raw materials and equipment, or both.

At the present time, the Government can only act indirectly to force a reduction in the creation of credit. For example, an increase in the rediscount rate charged by the Federal Reserve System will act to increase interest rates in the economy. Such an increase in interest rates causes a rise in the charges levied for the extension of credit. This will discourage some individuals and firms from making use of additional credit and will serve to relieve some of the inflationary pressure. If such measures prove insufficient to halt a credit inflation, it would be possible for the Government to adopt a program of the direct control of credit. Such control, however, is extremely difficult to administer adequately and probably should be undertaken only in the case of war or of extreme emergency.

Cost inflations are radically different from purchasing-power inflations. The problem here is that the money costs of the factors of production rise more rapidly than does the productivity of these factors. The most important type of cost inflation is wage inflation. In this situation, the wages paid to labor increase faster than does labor productivity. An increase in unit cost of production is almost inevitable.

A portion of this increase in the unit cost of production is usually absorbed by the manufacturer through reduced unit profits. There is, however, a definite limit to the degree to which profits can be shaved. A drop in unit profits ultimately affects the ability of management to pay dividends. If dividends continue to drop, investors become disinterested and management is unable to raise the money capital required to expand or even to maintain production. Thus, the time comes when management must raise the price of the company's products in order to protect the company's ability to produce. This increase in price does not reflect an improvement in the quality of the

product but rather the fact that wage rates are rising more rapidly than is labor productivity.

The answer to this problem is to prevent wages from rising more rapidly than does labor productivity. Such unwarranted wage increases are made possible by a number of monopolistic practices sponsored by labor unions. The right to strike and thus to halt production within an area of our economy carries with it the responsibility to society as a whole to see that strikes, or the implied threat of strikes, do not result in wage increases unmatched by increases in labor productivity. Few unions appear to worry about this responsibility. The result is that some segments of the labor force are able to secure unwarranted wage increases and, thus, to benefit at the expense of the consuming public which must pay higher prices to foot the bill for such unearned wage increases.

Supply-failure inflations are not as common as are purchasing-power inflations or cost inflations. These inflations result when, for one reason or another, an insufficient supply of goods and services flow into the market to meet the demands of the consumers. Such inflations affect the entire economy only in those relatively rare instances when some catastrophe such as war has acted to reduce materially the entire productive capacity of an economy or, at least, to reduce that portion of the productive capacity which can be devoted to the creation of goods and services for civilian consumption.

More commonly, supply-failure inflations affect only one segment of the economy. A general crop failure will reduce the supply of food with a consequent sharp increase in food prices. A producers' monopoly deliberately contrived for the purpose of increasing prices would cause a form of supply-failure inflation.

The answer to this type of inflation is to increase the supply of the commodities affected. If supply cannot be increased rapidly from sources within the economy, it must be imported until local production units are capable of meeting the demand. Factories devastated by war or other catastrophe must be replaced as quickly as possible. Crop failures can be met by importing food until a new crop can be harvested. Producer monopolies must be, and are, prohibited by law.

Although much remains to be learned about inflation, it has become obvious that it is a complex matter and that, actually, there are a number of different kinds of inflation. It is probable that more than one type of inflation is at work during any given inflationary period. There is no one remedy that the Government can adopt in a fight against inflation. Adequate Government action in any inflationary period requires a comprehensive analysis of the specific pattern of factors which are in action. Only when this pattern is understood will it be possible for the Government to determine an effective course of action.

Section 2. The Effect of Government Fiscal and Monetary Policy and of the Structure of Corporate and Private Debt Upon Economic Stability

There are a number of forces within an economy which have impact upon the stability of this economy. Examples include businessmen's expectations concerning the future (optimism or pessimism), the pattern of consumers' demands for goods and services, the avail-

able supply of money capital, interest rates, the rapidity of change in production technology, the debt structure, Government fiscal and monetary policies, and so on.

These forces are subject to varying degrees of manipulation by those who would like to influence or direct the course of the economy. The fact that these forces are interrelated and that they are linked together in ways which are complex and imperfectly understood calls for the exercise of considerable caution and good judgment by those who would influence the course of economic events.

A. GOVERNMENT FISCAL AND MONETARY POLICIES

Measures adopted at the various levels of government (Federal, State, and local) in the area of fiscal policy and those adopted by the Federal Government in the area of monetary policy have an important effect upon the general level of business activity. While fiscal policy and monetary policy exert their influence upon the economy through slightly different channels, each of them has an effect upon the other. It is important to remember this fact for the economic effect of a policy adopted in the area of monetary management may be nullified by a policy adopted in the area of fiscal management.

The roles of the Treasury Department and the Federal Reserve System

Fiscal policy relates to the level of Government expenditures and income and to management of public debts while monetary policy relates to management of the Nation's supply of money. In the administrative branch of the Federal Government, the implementation of fiscal policy is primarily the responsibility of the Treasury Department while the Federal Reserve Board is primarily responsible for monetary policy. Federal fiscal policy is laid down by the Congress although the Treasury Department plays some part in the establishment of such policy through its management of the current Federal debt and through its recommendations relating to tax and budget matters. Congress appears to play a much smaller role in the area of monetary management, with the Federal Reserve Board doing most of this work, although the fundamental authority of Congress in this area cannot be denied.

It is evident that fiscal and monetary policies have an impact upon each other. Thus, an increase in interest rates brought about by Federal Reserve Board action in increasing the rediscount rate will force the Treasury Department to increase the interest rates it offers on Government bond issues and will affect the number of tax dollars which must be used to pay interest on the Federal debt. A reduction in the Federal debt, an action taken by the Treasury Department, which involves redemption of Government bonds held by individuals (rather than by the banking system) will tend to increase the amount of currency in circulation and will affect the problems faced by the Federal Reserve Board in managing the Nation's money supply.

It is important, however, to recognize the fact that the basic goals of fiscal policy may differ from the basic goals of monetary policy. For example, fiscal policy should be aimed at efficient management of the Federal debt and at making it possible for the Government to provide essential services at a minimum expense to the taxpayers. On the other hand, monetary policy should be aimed at managing the

money supply in such a manner as to contribute to the stability of the economy and to make possible a reasonable and orderly rate of growth in the economy. The Treasury Department and the Federal Reserve System should be sufficiently independent of each other as to enable each of these agencies to achieve its basic goal.

The problems that arise when such independence is not permitted can be illustrated by the history of the monetary control policies of the Federal Reserve Board from 1952 to 1957.

The fact that the necessity of financing heavy defense expenditures during World War II would require an enormous expansion of the Federal debt was a cause of concern to those charged with responsibility for fiscal policy. It was necessary to assure a market for huge issues of Government bonds without impairing the credit of the United States. In order that the prices of these bonds in the open market might not fall below par, the Federal Reserve System was required to engage in open market operations to support these prices. Such a requirement took precedent over policies which would represent the most efficient management of the monetary system which is the basic responsibility of the Federal Reserve System.

Support of the Government bond market by the Federal Reserve System during the war may well have been justified. The overriding importance of maintaining an active demand for Government bonds at par or above is apparent. The relatively low interest rates which prevailed in the economy as a result of this policy undoubtedly helped to provide for a more rapid expansion of our industrial capacity during wartime than otherwise would have been possible. These low interest rates also helped to keep to a minimum the burden of servicing the rapidly expanding Federal debt.

Justification for maintaining such a policy in the period extending from the end of World War II to 1950 is more difficult to find. The inflation which occurred during the latter half of the 1940's was a combination of a supply-failure inflation and a purchasing-power inflation. The supply of consumption goods flowing into the market when rationing was abandoned was not sufficient to meet pent-up civilian demand which had been postponed during the war. Money supply had been increased rapidly during the war and a considerable portion of this increased money supply rested in the hands of consumers as idle balances. The result was a sharp decrease in the purchasing power of the dollar.

It is improbable that the Federal Reserve Board would have continued to maintain a policy that resulted in low interest rates and a bountiful supply of money in the face of a 25-percent cut in the purchasing power of the dollar during the short space of 5 years had it not been required to support the price of Government bonds. Prudence called for a policy designed to reduce the money supply and to allow interest rates to seek a more realistic level. Higher interest rates would have increased the rate of saving. This would have reduced the quantity of purchasing power seeking goods and services and, thus, would have tended to put a brake on the erosion of the value of the dollar. It also would have made more money capital available for expansion of the productive capacity of the consumer goods industries.

Forcing the Federal Reserve Board to continue to subordinate its function of manager of the monetary system to the Treasury Depart-

ment's role as manager of the Federal debt after the war was over was a costly move. Whatever advantage the American public gained from having Federal debt refundings accomplished at a low interest rate was far overshadowed by the incalculable harm done by the erosion of the purchasing power of the dollar.

With the accord of 1951 wherein it was freed from the requirement that it support the Government bond market, the Federal Reserve Board was permitted to return to its primary task of managing the monetary system. The responsiveness of the monetary system to the needs of the economy improved at once.

No one contends that our monetary system has been perfectly managed since the accord. It is possible, for example, that the rediscount rate was lowered too quickly in response to the 1953–54 recession. But the improvement over the situation which existed prior to 1951 is obvious. The Federal Reserve Board is to be commended for its courage in raising the rediscount rate despite considerable opposition when inflation again became a problem in 1957. However, the fact that the efforts of the Board have not been completely effective in halting the decline in the purchasing power of the dollar shows once again that manipulation of the rediscount rate and of reserve requirements are not in themselves sufficient to stem a strongly inflationary tide.

It has been pointed out that fiscal policy and monetary policy, despite the fact that each has an effect upon the other, seek different goals. It follows that the Federal agencies responsible for the execution of these policies, the Treasury Department and the Federal Reserve Board, should be allowed to operate independently of each other insofar as is possible. It remains to trace some of the channels by which fiscal policy and monetary policy affect economic stability.

2. The effects of fiscal policy upon economic stability

The three major aspects of fiscal policy which affect economic stability are Government spending, Government taxation, and management of Government debt. The general economic effect of the first two aspects is approximately the same whether the spending and taxing is being done by Federal, Stater, or local governments. In the case of the third aspect, there is a significant difference in the economic impact of management of the Federal debt and management of State and local government debts.

(*a*) *Government spending.*—In a free-enterprise economy, spending patterns have a profound effect upon the production sector of the economy. Changes in production patterns always follow changes in spending patterns. A decrease in the demand for a commodity or service is always reflected by a drop in the spending for that commodity or service. Producers must revive the demand for their products, must shift to the production of other products, or must face financial failure.

Federal, State, and local governments accounted for one-fifth of all the spending in the United States economy in 1957. Shifts in Government spending patterns will be mirrored by consequent changes in United States production patterns. Production pattern changes often cause dislocations which affect management, labor, and investors alike. Abrupt shifts in Government spending patterns offer a serious threat to economic stability.

Government spending affect economic stability in other ways. Government purchases of strategic raw materials for stockpiling in periods of inflation acts to push these raw material prices even higher. Government spending for public-works-type projects in periods of full employment can pull productive factors away from the creation of additional goods and services available for consumption and, thus, add to inflationary pressures. Spending by State or local governments on ill-conceived projects can be as harmful as is an equal volume of unwarranted spending by the Federal Government.

(*b*) *Government taxation.*—Taxation by Government units affects economic stability in several ways. It must be recognized that however necessary taxation may be to the existence of organized government, it does take from the individual the right to determine the manner in which a portion of the money he earns by his labor should be spent and places the right to determine the pattern of the spending of this money in the hands of Government agencies. Unless the Government agencies are as determined as are most individuals to see that this hard-earned money is well spent, economic stability is threatened.

Taxation is one of the tools that can be used to adjust the money supply to the needs of the economy during periods of inflation or deflation. Increased taxes will act to reduce the quantity of money in circulation (if the increased taxes are used to redeem Government bonds held by banks) and thus to reduce the pressure on prices in periods of inflation. A reduction in Taxes in periods of severe deflation will increase the supply of money and will help to bring about economic recovery.

An income-tax structure which is so highly progressive as to seriously diminish incentive is inflationary in nature. Talented managers are often loath to accept positions of increased responsibility when most of the added income paid to compensate the individual for the additional effort he must put forth is taxed away. Those with accumulated savings often conclude that the after-tax return is disproportionate to the risk. Even the skilled laborer may voluntarily limit his hours of work when he finds himself in the higher tax brackets. And yet the only manner in which additional goods and services can be provided in our society is by prevailing upon men of ability and those who supply capital to undertake the additional effort and risk which such increase in the supply of goods and services requires. The only way to offset the increased demand occasioned by our expanding population without inflation is to keep expanding the available supply of goods and services. Anything which interferes with this process generates inflation.

There is an even more fundamental manner in which a distorted income-tax structure affects the fabric of a free enterprise society. To seek security in the face of the uncertainties of life and the infirmities of old age is to respond to the basic human drive for self-preservation. In the past in this country, such a drive has led men to seek the greatest amount of income permitted by their own abilities and to save as much of this income as possible. They were attempting to provide their own security and that of their family.

However, when a distorted income-tax structure renders it almost impossible for the individual to secure a sufficiently high after-tax level of income to make provision for his own security, he will look

elsewhere for this security. The only agency which appears ready, willing, and able to shoulder this burden is the very Government which is taxing away his self-dependence. From this point on, two roads are open. The individual can follow a dictator who promises protection and security or he can throw himself into the arms of the Socialists who promise that an all-controlling Government will provide his security. Both of these roads lead away from a free-enterprise society. A way of life which in the past has earned for us an unmatched standard of living coupled with a degree of individual freedom which is unique in history is in the process of being taxed to death.

Like results obtain when progressive estate tax rates approach confiscatory levels. If a man knows a substantial portion of what he accumulates for the security of himself and his family will be taken by the Government at his death, a forceful incentive to produce and save is removed.

(*c*) *Management of the public debt.*—The stability of an economy is affected by the structure of debt within that economy. However, that portion of the debt structure which is represented by Government debt differs considerably from corporate and private debt and its management presents a unique series of problems and opportunities.

Government debt is different from corporate and private debt in several important ways. Generally, money is lent to corporations or individuals on the basis of their ability to create through their own efforts sufficient income to permit repayment of the loan and of their possession of assets large enough to cover the value of the loan. The Government, however, creates little income of its own. Rather, it relies on its ability to tax the incomes created by corporations and individuals in order to secure funds with which to repay money lent to it. Further, Government assets do not stand behind most loans made to the Government. The security involved, in reality, is this same ability to tax.

The upshot of these matters is the fact that the incomes and assets of corporations and individuals in this country are subject not only to the liens established by their own borrowings but also to liens established by Government borrowing (anyone who fails to pay his taxes finds that both his income and his assets are subject to confiscation).

Prudent management of the public debt requires recognition of this fact. If the public debt is allowed to expand more rapidly than does the ability of corporations and individuals to create income, the liens thus established upon income and assets will finally become too great to be supported. Some individuals and corporations will face the intolerable situation of being taxed out of business and being forced into bankruptcy not as a result of their own mismanagement but as a result of unwise Government fiscal policy.

Government debt is an important segment of the total debt structure in this country. In December of 1956, it equaled $327 billion or 41 percent of our total debt structure of $793 billion. Federal Government debt was at the level of $277 billion (about 85 percent of total government debt) while State and local government debt amounted to $50 billion.

State and local government debt differs somewhat from Federal debt in its impact upon economic stability. A much greater propor-

tion of State and local government debt is funded than is the case with the Federal debt. When a sinking fund is being accumulated, retirement of the debt at maturity is being provided for automatically without requiring further action on the part of State or local officials. Federal bonds do have a maturity date. However, the lack of a sinking fund means that some decision is required at the maturity date as to the manner in which the money required to pay the bond is to be raised. As a rule, it is decided to issue a new bond to pay for the maturing bond. Thus, there is a somewhat greater possibility of State and local government debt being decreased than is the case with the Federal debt.

A more important difference between the two types of government debt is the fact that Federal Government bonds can be used as a reserve against the issuing of Federal Reserve bank notes or as a part of the reserves which banks are required to maintain against deposits. This is not true, of course, of State and local government bonds. This ability to monetize the Federal debt affects the stability of our economy and creates some acute problems in the area of monetary management.

An increase in the Federal debt is likely to result in an increase of the quantity of Federal Reserve notes in circulation and in a growth in demand deposits. A decrease in the Federal debt may result in a decrease in these two portions of the money supply. Such more or less involuntary changes in the money supply may not meet the monetary needs of the economy at the moment. The problems of monetary management are thereby increased. The growth of the monetized Federal debt since 1940 unquestionably has contributed to the pressure of inflation.

3. The effect of monetary policy upon economic stability

While fiscal policy managers must take into consideration the effect of their decisions upon the level of economic activity, the primary goal of fiscal policy is to finance the operations of government. The primary goal of monetary policy, however, is to adjust the supply of money (including demand deposits) to the needs of the economy.

There are two schools of thought relative to the manner in which these needs should be met. There is a group which maintains that monetary policy should be essentially a passive factor in the economy; this is to say that the money supply should be manipulated in such a way as to adjust to the current demand for money in the economy. This group recognizes the fact that economic change is inevitable but feels that such change should be the result of factors other than monetary policy. This approach lays stress upon the development of policies which provide for an automatic adjustment between money supply and current demand for money.

A second group takes the position that monetary policy should make a firm contribution to economic growth, that it should be an active factor in the economy. The need for maintaining a degree of equilibrium while the economy grows, and the importance of monetary management policies to this equilibrium, is recognized. However, monetary management should stress those policies which will stimulate economic growth in the view of this second group.

An example of the difference in the basic policies advocated by these two groups is their approach to the question of interest rates. The

first group contends that the interest rate should be determined by the relation between the demand for money and the supply of savings. They admit that the production sector of the economy may not grow as rapidly in this case as it would if interest rates were forced to a lower level. However, they feel that the growth in capital goods should be limited to the rate of growth in savings. Otherwise they contend that the economy will suffer a long-term inflationary trend.

The second group feels that the interest rate should be forced to a somewhat lower level than would be the case if it was determined solely by the relationship between the demand for money and the supply of savings. This can be done by, among other things, having the Federal Reserve Board maintain a relatively low rediscount rate and reserve requirement. Such a policy creates low interest rates both directly, because of the close relationship that exists between interest rates and the rediscount rate, and indirectly, because of the consequent increase in the supply of money. This low interest rate, says the second group, will stimulate business investment to rise to higher levels. They feel that the growth in the quantity of goods and services available for consumption brought about by this increased business investment will be great enough to eliminate the danger of long-term monetary inflation.

A discussion of which of these points of view represents the position that should be adopted by the Government belongs in sections 3 and 4 of this report. The point to be noted here is that one of the ways in which monetary management affects economic stability is in the impact of monetary policy upon interest rates.

Monetary policy can affect economic stability in one other way. Inept monetary management can result in an erosion of the purchasing power of the dollar which is so rapid that the people begin to fear for the fundamental stability of the currency. The result is a full-blown financial panic. The velocity of money increases tremendously, there is a flight of capital from the country, speculation becomes rife, and economic chaos ensues. The German inflation subsequent to World War I is a classic example of such a panic. It may seem incredible that such a situation could develop in this country but the possibility, remote as it may appear, is always present.

B. THE STRUCTURE OF CORPORATE AND PRIVATE DEBT

The effect of Government debt upon the economy has been discussed earlier in this section of this report. The other portion of the total debt structure, corporate and private debt, also has a series of effects upon economic stability. Some of these effects stem from the sheer size of corporate and private debt, that is, the relationship between the quantity of such debt in existence and the quantity of goods and services being produced at any given time. Other effects are the result of the various types of uses to which the borrowed money has been put. Finally, the relationship between the growth of debt capital and equity capital has important implications for economic stability.

When debt is incurred as a result of the transfer of money from one individual to another, as when a man pays cash to a corporation for one of its bonds, there has merely been a transfer of money. The total supply of money has not been increased. However, when this same corporation goes to a bank for a loan the situation is different.

The funds are made available by a demand deposit created by the bank to the order of the corporation. The bank must maintain against this demand deposit a reserve in cash (or in Government bonds) equal to only a portion (11 to 19 percent) of the amount of the demand deposit. Total money supply has been increased by the difference between the amount of the demand deposit and the amount of the reserve. The major share of corporate and private short-term debt, of course, has been created by the demand-deposit route rather than by the direct transfer of funds from creditor to debtor. Thus, much of the corporate and private debt existing in this country has resulted in an expansion of the money supply.

A rapid expansion of corporate and private debt can lead to economic instability. Increases in consumer debt that enables effective demand to exceed supply is inflationary. Increases in producer debt of such a magnitude that they lead to overbuilding of productive capacity is inflationary in its first effect as it bids up the prices of labor, raw materials, and equipment. At the same time, it lays the groundwork for subsequent deflation as productive capacity becomes increasingly greater than current demand.

The use to which borrowed money is put has much to do with the effect of debt upon economic stability. Money borrowed for the purpose of commodity speculation has an inflationary effect which is especially pronounced in periods of full employment. Money borrowed for the purpose of building producing facilities which will take several years to come into production is generally more inflationary than is money borrowed to create working capital. Money borrowed to finance inventory speculation has an immediate inflationary effect.

Corporations face two general possibilities when it comes to increasing their capital. They can resort to debt financing or equity financing. As a general rule, corporations prefer to engage in debt financing when they anticipate inflation and to engage in equity financing when they expect deflation.

The relationship between the quantity of debt capital and the quantity of equity capital in an economy has some interesting implications during periods of economic change. This is especially true when the ownership of corporate bonds and corporate stocks is widely dispersed among the consuming public. An economy which is characterized by a relatively large proportion of debt capital may resist the early stages of a deflation more successfully than will an economy in which there is heavy reliance upon equity capital. While dividends tend to drop early in a deflation, bond interest payments are made by corporations as long as it is possible to do so. Bondholders will find their purchasing power curtailed to a smaller degree than will stockholders. Thus, in economies wherein there is a large percentage of debt capital, consumers' purchases may not drop off as rapidly in the early stages of deflation. On the other hand, these economies may spend more time in the depths of a serious deflation than will economies wherein equity capital is more prevalent. The burden of meeting bond interest payments may throw a number of corporations into bankruptcy in such a situation. This creates a form of economic chaos which is most difficult to combat.

Section 3. Appropriate Goals of Government Economic Policy

A. THE FREE ENTERPRISE ECONOMY VERSUS THE CONTROLLED ECONOMY

Decision as to the goals which are appropriate for Government economic policy must be based upon a clear understanding of the nature of the free-enterprise system. The controlled economy system, which is the economic aspect of the philosophy of collectivism, relies upon Government planners to direct the course of virtually all of the production in an economy. This system is closely allied with the concept of the welfare state wherein differences in individual incomes are eliminated and everyone is provided with the same standard of living under the watchword security for all. The free-enterprise system, which is based upon the philosophy of individualism, in essence leaves the direction of the course of production to the entire group of producers in the economy who must submit to the discipline of the market. This market is the means whereby the consumers indicate their preference for the specific types of goods and services they wish to consume.

The fatal weakness in the controlled economy system is the inability of human planners to forecast the future or to measure the present. Yet both of these functions must be undertaken if a central agency is to plan and direct production. No system of surveying and no set of questionnaires is as effective in measuring consumer's desires as is the actual decision of the consumer to spend his money for specific goods and services in the market.

In the matter of forecasting, the free-enterprise system provides a measure of protection for the economy. The planners in a controlled economy must come to some agreement in their forecasts of demand, size of harvest, weather, and so on. The agreed-upon forecast becomes the basis of all production planning. Everything goes well if the forecast proves accurate, but if the forecast is inaccurate the results can be disastrous for the entire economy. Under a free-enterprise economy, each of a myriad of products bases his plans upon his own forecast and these forecasts vary widely. Some producers will have forecasted incorrectly and they will suffer individually. However, other producers will have forecasted correctly and they will prosper and will provide a source of strength in the economy.

The welfare-state type of planned economic system reflects a fear of the future and a consequent desire for security on the part of the individual. There is little appeal to individual initiative in a situation wherein all persons are provided with substantially the same standard of living. Most men will content themselves with the minimum of productive activity permitted by the planners. The free-enterprise system places a premium upon individual initiative. Generally, the highest standard of living is enjoyed by those who are contributing most to the production of goods and services. Each man is subjected to a strong economic incentive to produce to the limit of his ability. The result is a much larger flow of goods and services than is the case under a planned economy with a much higher average standard of living as the result.

The free-enterprise system continues to provide this country with the highest living standards and the greatest amount of personal freedom in the world today despite constant encroachment by those

who favor control of the economy by the state. If Government economic policy is not to cripple the ability of the free-enterprise system to provide the foundation for our way of life, Government policymakers must work within the framework of an understanding of the economic requirements of this system.

B. APPROPRIATE GOALS OF GOVERNMENT ECONOMIC POLICY UNDER THE FREE ENTERPRISE SYSTEM

The fundamental requirement of the free-enterprise system is freedom of action. Consumers must be free to make their consumption choices without coercion, producers must be free to compete with maximum effectiveness, and labor and capital must be free to seek their highest possible rates of return. The problem is to preserve the maximum possible degree of freedom for all concerned. The freedom of producers to compete must not interfere with the freedom of consumers to make intelligent consumption choices nor with the freedom of labor and capital to flow to their highest rate of return. The freedom of labor to organize must not interfere with the freedom of producers to compete or of consumers to consume.

Admittedly this is a difficult problem. Monopoly, whether it be a producers' monopoly, a labor monopoly, a consumers' monopoly, or a monopoly of capital, tends to interfere with this fundamental freedom. One of the goals of Government economic policy should be the preservation of such freedom.

The importance of individual initiative to the free-enterprise system has already been pointed out. Government economic policy must act to provide an environment within which individual initiative can flourish.

Free-enterprise economies and controlled economies alike are subject to fluctuations in the level of economic activity. Some of these are caused by forces generated internally within the economy while others are the result of the impact of outside factors. Some degree of fluctuation is inevitable and desirable, for this represents the economy's attempt to regain its balance. Thus, when inventories grow too large production must be curtailed until the excess inventories are worked off. When productive capacity has expanded too rapidly, business investment in new facilities must decrease until demand has an opportunity to catch up. Preventing economic fluctuations of the corrective type results in an increasing unbalance in the economy until the whole structure collapses. The problem, then, is not to eliminate economic fluctuations but to keep them from getting out of hand.

Government economic policy in the matter of economic fluctuations must seek two goals. It must attempt to maintain sufficient flexibility in the economic structure to enable this structure to undergo corrective fluctuations. At the same time, it must attempt to keep fluctuations from degenerating into severe inflation or deflation.

There is a strong tendency for the free-enterprise economy to grow. This is not only the result of population increase but also of the determination of individuals to enjoy a higher standard of living. The stimulus of individual initiative coupled with the desire for an increase in real income leads to a rapidly developing technology and an expanding capacity to produce. Government economic policy should attempt to foster such growth.

In summary, the economic policy of the Government should be directed toward providing a climate conducive to the most effective operation of the free-enterprise system. Basic goals of the Government should include (1) the elimination of barriers to the freedom of action of, and yet prevent monopolistic practices by, consumers, producers, laborers, and capital; (2) the stimulating of individual initiative; (3) maintenance of the flexibility of the economic structure; (4) prevention of severe inflation or deflation; and (5) the fostering of a healthy rate of growth in the economy.

Section 4. Suggested Policies for the Achievement of These Goals

The previous sections of this report have attempted to provide a background for suggestions as to specific economic policies which should be established by the Federal Government. The various types of economic instability have been discussed with emphasis on inflation. The effects of Government fiscal and monetary policy upon economic stability have been explored. A statement has been made as to those goals which are appropriate for Government economic policy in our type of society. All that remains is to spell out the economic policies suggested by this background.

PREVENTION OF SEVERE INFLATION OR DEFLATION

As was pointed out in section 3, it is neither necessary or desirable for the Government to attempt to eliminate all fluctuations in the level of economic activity. However, there is always the possibility that one of these movements will gather a momentum which leads to severe economic dislocation and this must be prevented. One of the goals of Government economic policy must be to prevent severe inflation or deflation.

The structure of the economy of the United States is complex and the interrelationships which exist between its various segments are not completely understood. It is obvious, however, that no two periods of inflation or deflation involve exactly the same factors and that the course of economic events is never quite the same in any two periods. An understanding of the current situation and of the events which led up to it is a prerequisite to effective Government action.

It appears that the economic situation which confronts us today developed in the following manner. Recovery from the economic valley of August 1954 was sparked by a rapid increase in the rate of business investment. The resulting increase in employment in the capital goods area stimulated consumer purchasing. As sales increased, retailers began to expand their inventories. This inventory rise was probably caused not only by the need to meet increased sales levels but also by the fact that retailers anticipated an upward movement in price levels. They wanted to take advantage of the opportunity to make an inventory profit.

Most of the anticipated price increases did not materialize immediately. The average level of wholesale prices rose only four-tenths of 1 percent between 1954 and 1955. However, average hourly wage rates in manufacturing rose by 3.9 percent in 1955, by 5.3 percent in 1956, and by 4.5 percent in 1957. These increases in wage costs began to

force up prices and wholesale prices climbed 3.3 percent in 1956 and 3.7 percent in 1957. One of the important causes of this price rise was the fact that hourly wages were increasing more rapidly than was labor productivity.

The increase in labor costs per unit of output which exceeded the increase in the price at which that unit of output could be sold acted to make management pessimistic about the probable course of future profits. Management's problem was compounded by the fact that the cost of money capital was also rising rapidly. Interest rates, as indicated by the rate of return on AAA corporate bonds, rose by 5.5 percent in 1955, by 9.8 percent in 1956, and by 15.8 percent in 1957. This increase in interest rates reflected the fact that the rate of demand for money capital was increasing much faster than was the rate of saving. Between 1954 and 1957, gross private domestic investment increased by 33.1 percent while personal savings rose only by 12.8 percent.

Toward the end of 1956, surplus producing capacity became evident in a growing number of industries. This, coupled with rapidly rising labor costs and interest rates, caused a number of businessmen to review their expansion programs and to begin some pruning. Gross private domestic investment dropped from $65.9 billion in 1956 to $64.4 billion in 1957. The effect was felt almost immediately in primary metals production, which began to slip after a peak in September of 1956, and in machinery manufacture which peaked in December of the same year.

Nonagricultural employment continued to rise until it reached a peak, on a seasonally adjusted basis, in August of 1957. By January of 1958, nonagricultural employment dropped by 2.1 percent from the August peak. However, average weekly hours worked in manufacturing began to decline in January of 1957 as did average weekly earnings in manufacturing. In February sales began to drop, with the rate of decline becoming exceedingly pronounced by October of 1957.

Despite the drops in the quantity of goods produced, in employment, in weekly hours worked, in weekly earnings, and in sales, both retail and wholesale prices continued to rise and are still rising. It is not necessary to look far to find the cause. Hourly wages in all manufacturing continued to rise until December of 1957 and are now continuing at just one cent below this peak. With manufacturing output declining and hourly wages rising, labor costs per unit of production have increased rapidly. Since the last quarter of 1956 corporate profits before taxes have successively decreased each quarter as corporations, caught in the squeeze between rising labor costs and declining sales, have fought to hold down the prices of their products.

Those who fail to understand how it is that inflation can continue in the face of unemployment and sales declines, are guilty of a naive view of inflation. The present situation is an excellent example of a cost inflation. The naive view of inflation, which is based upon the classical school of economics, holds that wage rates will decline as unemployment grows and that this decrease in labor cost will allow producers to lower their prices as sales decline. Actually, producers today are sacrificing profits in a desperate attempt to keep prices from rising and they are only partly successful in this effort.

Organized labor and labor wage contracts generally act to prevent any substantial lowering of wage rates in a recession, thus introducing

an element of rigidity into the economy. The leader of one of the major unions recently informed management that the union preferred layoffs to a reduction in hours worked. He relied on unemployment benefits to support those workers who lost their jobs. In the meantime, wage escalation clauses which tie wage rates to the cost of living will continue to bring about wage increases which will themselves increase the cost of living and thus generate further wage increases.

It is sometimes argued that these wage increases place more money in the hands of consumers and that this is a good way in which to combat declines in sales volumes. Such an argument fails to consider the fact that such wage increases act to cause rises in unit costs, and thus in prices, unless they are offset by increased labor productivity. These price rises more than offset the increased purchasing power placed in the hands of consumers by the wage increases. This is evidenced by the fact that manufacturers' sales volumes have been dropping for a year despite the fact that wages have continued to rise during that year.

Manufacturing production dropped during the first half of 1957 as firms attempted to reduce their inventories in the face of a decline in the sale of capital goods. This attempt was unsuccessful, since sales of capital goods continued to drop more rapidly than did output, and manufacturers' inventories reached an all time high in August and September of 1957. In October, output was cut in earnest (manufacturing output dropped 2.7 percent in the month of October alone) and the inventories began a decline that has continued ever since.

Retail sales have held up surprisingly well (with some difficulties apparent in department store sales) despite a drop in total personal income which began in November of 1957. An expansion of outstanding consumer credit has acted to prevent a retail sales decline. There has been no significant decrease in retail inventories on a seasonally adjusted basis.

This discussion of the course of economic events during the past 15 months has not been exhaustive. However, enough has been said to indicate the fundamental causes of the present decline and, thus, to suggest the type of policies which should be adopted by the Federal Government in its efforts to prevent a severe recession.

The root of the present economic difficulties lies in the area of business investment. The drop in the rate of business investment was brought about by a rise in unit labor costs, in the cost of money capital, and by the development of overcapacity in some industries. This is not an inventory recession in the same sense as was true in 1949 although difficulties in liquidating manufacturing inventories has compounded the problems brought about by the decline in business investment. Consumer demand generally has held up surprisingly well despite rising prices and some decline in personal incomes. Retail inventories do not appear to be excessive. The continuing decline in the purchasing power of the dollar is the result of a cost inflation rather than a monetary inflation or a supply-failure inflation. The drop in employment is a result of rather than a cause of our economic difficulties.

There are three fields of action open to the Government in its effort to stem an economic decline although the three fields are to some extent interrelated. The Government can take action relative to the interest

rate and the supply of money, relative to purchasing power and demand, and relative to employment. Government action in connection with the interest rate and the supply of money generally involves Federal Reserve Board manipulation of reserve requirements and the rediscount rate. Changes in Federal tax rates, in the length of time over which unemployment insurance payments will be made, in the rates of pay granted to Federal employees, and in the quantity of goods and services purchased by the Government all have a direct effect upon demand and purchasing power. The Government can directly increase employment by a program of public works.

The general pattern of action which the Government should adopt in combating a given economic decline depends upon the fundamental nature of the decline. In the present circumstances, Government policy should be aimed at reversing the trend of business investment. However, this policy must take into consideration the fact that we face a groundswell of inflation in this period of cold war. Government action should contribute as little as possible to the long-term inflationary pressures. When the economic decline has been halted, the Government must once again be prepared for an active anti-inflation campaign.

There are several opportunities available to the Government today which would increase the rate of business investment. There is little that the Government can do about the problem of excess productive capacity in some industries. However, lower interest rates can be accomplished by Fereral Reserve Board action by means of lowering the rediscount rate and reserve requirements and through purchasing Government bonds in the open market. Perhaps most important, the Federal Government should today attempt to influence organized labor to refrain from seeking wage increases or additional fringe benefits until such time as labor productivity catches up with labor compensation. Modification of the antitrust laws would be most timely since unjustified wage rates frequently are secured as a result of industrywide bargaining made possible by the exemption of labor unions from the Federal antitrust laws. A reduction in the corporate income tax should act to increase the current rate of business investment.

A reduction in total personal income tax collections should await concrete evidence of a decline in consumer purchasing. If such a reduction is granted, it should be for a specific limited period. Permanent tax reductions must await a decrease in Government spending. Government deficits are inflationary in their effect and a Government budget surplus is an important factor in the long-term fight against inflation.

An ambitious program of public works should not be undertaken by either the Federal Government or by State governments at this time. Such programs are appropriate only in the case of prolonged depressions, if then. Public works programs, for the most part, require so long a period of preparation that they will be of little real aid in combating the present cyclical decline. By the time these programs are in full swing, inflation will once again be the prime economic problem and such programs are inflationary in their effect. Public works programs are generally aimed at relieving unemploy-

ment. Unfortunately, the type of laborers required in such programs often are not the type of laborers who are unemployed.

In summary, Government economic policies designed to combat economic disturbances of a cyclical nature must be appropriate to the specific set of factors underlying any given disturbance. The Government must recognize that the goal of its economic policies in such a situation is not to completely eliminate economic fluctuations but to moderate them.

MAINTENANCE OF FLEXIBILITY IN THE ECONOMIC STRUCTURE

Moderating economic fluctuations is an important facet of Government economic policy. Perhaps an even more fundamental function of Government economic policy in a free-enterprise economy is to aid in maintaining the flexibility of the economic structure. Among the policy areas which might be studied in this connection are the following:

1. Reversal of the tendency to concentrate Government activities at the Federal Government level rather than at the State or local government level.
2. Make certain that the tax take does not increase in the future as rapidly as the increase in gross national product.
3. Wider dispersal of Federal Government bonds among the general public, insurance companies, and pension funds rather than in the banking system.
4. More effective separation of the policy activities of the Federal Reserve Board and the Treasury Department.
5. A more effective policy for reducing the Federal debt when economic activity is at a high level.
6. Moderation of the steeply progressive income tax structure, at both the Federal and State levels, in order to stimulate individual initiative.
7. Imposition of Federal general sales tax not only to generate additional revenue but also to impress the public with the additional tax burden which must result from increased Government expenditures for additional services demanded by the public.
8. Reconsideration of the Full Employment Act. In its present form, this act may place upon the Federal Government an obligation which forces types of Government action which are basically inflationary in nature.

GENERAL AMERICAN OIL COMPANY OF TEXAS,
Dallas, Tex., May 15, 1958.

Senator HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: With further regard to your request for my opinion on matters affecting the national economy, I appreciate greatly the opportunity to offer a few comments.

Others to whom you have addressed a similar request are better qualified than I to be helpful in providing direct answers to the specific questions you have raised. I would like to offer a few brief and more general comments as invited by your letter.

I believe that the history and experience of our country demonstrates that an expanding development and use of our national resources is a vital factor in the Nation's economic progress. This applies to all natural resources but I feel more qualified to confine my remarks to petroleum.

Careful studies have shown that there is a direct relationship between standards of living and energy consumption, both in the United States and throughout the nations of the free world. As I am sure you appreciate, petroleum (oil and natural gas) has become the predominant source of the energy that has been so essential to our expanding economy. Petroleum now furnishes about twice the amount of energy supplied from all other sources. It becomes important, therefore, that national policies in all fields such as taxation, foreign trade and economic programs be consistent in their objective to assure adequate supplies of energy at reasonable prices in terms of real cost to the consuming public. This may, and in fact does, require and justify differential treatment to recognize unique characteristics in the economic process of providing energy supplies. The differential tax treatment for oil and gas production provides an outstanding example of wise national policy that has benefited the economy through the assurance of adequate energy supplies at reasonable prices.

In your important and constructive investigation, I would offer the suggestion that Federal fiscal policies, foreign trade policies and other basic policies affecting the national economy be examined to determine whether they are fully consistent and effective in accomplishing the necessary expansion of natural resources in general and our energy resources in particular.

Hoping that this may be of some assistance and with appreciation for your consideration, I am

Sincerely yours,

GORDON SIMPSON, *President.*

INTERNATIONAL HARVESTER CO.,
Chicago, Ill., May 8, 1958.

HON. HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: Your letter and questionnaire dated February 17 and addressed to our recently retired president, Mr. Peter V. Moulder, has been referred to me for reply. I give below my answers to the questions, numbered in accordance with your questionnaire:

1. Inflation is any considerable general upward movement in the level of prices; deflation is any considerable general downward movement in the level of prices.

2. Both inflation and deflation usually reflect economic excesses which took place before the movement began. I believe that prevention is much better than cure. I do not believe that this can be greatly helped by legislation but rather by sound policies on the part of all elements in the economy.

3. Federal Reserve policy was handicapped during the period 1942–50 by the requirements of fiscal policy. The policy of maintaining a low level of interest rates made impracticable an effective monetary policy.

During the period since the accord, namely, 1951–57, the greater independence of Federal Reserve policy has been advantageous. I believe that, had it not been for the conservative policy of the Federal Reserve System during most of 1955–57, the present recession would have been more severe than it is.

4. The rise in the Consumer Price Index between August 1956 and September 1957 was due primarily to increasing labor costs. This in turn was a reflection of the high bargaining power of labor.

5. The management of the current public debt has a great impact on the financial markets and, therefore, on the access by industry to the funds which it requires. A skillful management of the public debt will minimize this potential conflict of interests.

6. (*a*) The three objectives are so closely interrelated that it is doubtful whether they can be usefully separated. If employment is maintained by measures which inflate prices, the stage will be set for an ultimately more serious unemployment. Relative price stability is the best foundation for sound and enduring economic growth.

(*b*) The most important trend since World War II, and particularly during the last 3 years, has been the steady increase in costs and particularly labor costs. While this has been a result of the increasing bargaining power of labor, it brought about during 1957 an increasing cost of many goods and services to the point of consumer resistance. This in turn has resulted in the increase of unemployment with which we are now confronted.

7. Current Government spending is a supporting factor in maintaining national income but, since much of such spending does not add to consumable goods, it tends to inflate costs.

8. Current taxation is at such high levels as to impair the ability and the incentive of both individuals and corporations to maintain and increase investment.

9. Fiscal policy embraces all of the financial transactions of Government and particularly of the Federal Government. Since the Federal Government is in a position to incur debt in whatever way it desires, it can interfere seriously with monetary and credit policy. On the other hand, if the Federal Government formulates its fiscal policy with due regard for the requirements of monetary and credit policy, each can reinforce the other. For example, monetary and credit policy cannot restrain inflationary trends in the face of sharply increasing Government expenditures and increasing Government deficits. The lengthening of the average maturity of the Federal debt would lessen the interference with monetary policy which results from frequent refundings by the Federal Treasury.

10. (*a*) It has been frequently pointed out that the monetary system, which used to function primarily through the commercial banks, is now affected also by many new types of financial institutions. The difficult question of whether direct controls should be extended to these other institutions could only be answered by a complete study by a qualified Commission.

(*b*) In very general terms, I believe that the tax structure of the United States has been built up with inadequate attention to incentives for investment and enterprise.

11. (*a*) The explanation of this paradox is that when labor costs are forced upward, prices follow; when this process has proceeded to a certain point, buyer resistance develops and the reduced demand results in unemployment. Prices do not decline because the increased costs are rigid, particularly when there are automatic escalation provisions in labor contracts.

(*b*) The acceptance of a gradual inflationary trend as desirable or necessary would be disastrous. If such a development were generally expected, it would encourage speculative policies, as opposed to sound economic policies, throughout the economy.

12. The growth of private debt increases the vulnerability of the economy to recession and tends to prolong and deepen the periods of inventory readjustment which occur from time to time. An individual or corporation which is heavily indebted will be more likely to reduce expenditures and investment drastically at the first sign of downturn. Furthermore, they will be less able to increase expenditures at the most advantageous time, when such increase would help to brake the downturn and stimulate recovery.

13. This is a matter of judgment which it is impossible to deal with by a formula. In principle, it would seem that, if an orderly liquidation of inventories is taking place, special measures are not required. If, however, the necessary liquidation of inventories fails to proceed in an orderly way, it can best be assisted by a tax reduction. This should be designed to stimulate investment as well as consumption, and would be more rapid and more direct in its effect than increasing public expenditures.

14. The Federal deficit has been a factor, but in recent years it has not been a major factor, in contributing to inflation.

15. Yes, by steadily increasing efficiency and productivity. Under reasonably stable conditions, this will produce a large and steady volume of investment.

16. No. As indicated in 11 (*a*), escalation provisions tend to force a continuous rise of costs and prices.

17. The basic cause of the present recession is the progressive increase in costs, which has priced goods beyond the ability or willingness of the public to pay. What is necessary is to check the rise in costs and to pass along to the consumer in reduced prices, to the greatest extent practicable, the benefits of increasing efficiency and productivity.

In the short term, if inventory liquidation does not continue in an orderly manner, a tax reduction will probably be desirable.

Sincerely yours,

WILLIAM R. ODELL,
Vice President and Treasurer.

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